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PARAGUAY

A STRATEGIC PLAN FOR ATTRACTING EXPORT-ORIENTED FOREIGN INVESTMENT

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FOREIGN INVESTMENT ADVISORY SERVICE (FIAS)
a joint service of
The International Finance Corporation (IFC)
and
The World Bank
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At the request of the Government of Paraguay, the Foreign Investment Advisory Service (FIAS), a joint service of IFC, MIGA and the World Bank, conducted its second advisory work on foreign direct investment (FDI) in February and March 1994. The objectives were to analyze Paraguay's advantages and disadvantages for attracting FDI, and to provide a strategic plan for further improving Paraguay's FDI environment.

The analysis and recommendations are based on about 50 in-depth interviews with private firms in Paraguay, Brazil and Argentina, on consultations with the Paraguayan Government, as well as with various international agencies, and on desk research done in Washington, D.C.

As stated in the report, the measures FIAS proposes do not stand in isolation from the on-going economic reforms that the Government has been pursuing in the past several years. The measures are, rather, stressed to give a sense of priority to Government activity, and to make clear the connection between broad reform measures and specific actions to improve the inflow of foreign investment.

This project was financed in part by the Centro Paraguayo para la Promocion de la Libertad Economica y de la Justicia Social (CEPPRO), drawing upon a grant from the United States Agency for International Development (USAID). Staff at CEPPRO and USAID provided logistical support and data to FIAS.

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A Strategic Plan For Attracting Export-Oriented Foreign Investment

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Executive Summary

i. The arrival of MERCOSUR, joining Brazil, Argentina, Uruguay and Paraguay in a free-trade area, is the most significant economic event to have affected Paraguay since the construction of the Itaipu dam in the 1970s. In order for the country to take full advantage of this historic opportunity, the Government needs to formulate a strategy and then to act decisively with this strategy as a guide.

ii. An export drive should be the centerpiece of the strategy. The limited size of the domestic market provides the motive for concentrating on exports, and the emergence of a unified regional market provides the means. In this drive for greater exports, foreign direct investment (FDI) will have a major role to play. It will be a critical source of capital, technology, know-how and marketing skill.

iii. Yet, as important as foreign investment will be for advancing exports, Paraguay is not adequately prepared to attract its full measure. Major policy reforms over the past few years, which are continuing today at good pace, have scored large successes in starting to transform a formerly paternalistic economy into a modern, efficient one. Paraguay, however, is competing against a number of powerhouses in the region, which have proved their strength in attracting foreign investors. Against the behemoths of Brazil and Argentina, Paraguay must develop niches of competitiveness, in which it can offer export-oriented investors the best opportunities for success in the region.

iv. This report is dedicated to the task of helping to find these niches and to identifying the steps that must be taken to exploit them. It builds on an earlier FIAS report, from 1993, that diagnosed investment barriers, but it goes beyond this previous work by pinpointing opportunities for FDI and indicating the steps to be taken to transform such opportunities into realities.

v. In so doing, the report makes no claim to have discovered new truths, since much of what is covered draws on well-known facts; the contribution is perhaps only to organize these facts into a strategic framework to guide action. Also, the report does not profess to be exhaustive at identifying investment opportunities. It undoubtedly misses some. In its defense, though, it can be said that if the Government acts to take advantage of the opportunities identified here, then the general results may have a positive effect on other opportunities, and may even help to create new areas for investment.

vi. While the report focuses on identifying niches for foreign investment in export-oriented activities, it is important in an overall strategic plan to stress the prominence that local investment must have in making Paraguay competitive within MERCOSUR and beyond. Indeed, national investors must lead the way in showing overseas companies that Paraguay is capable of offering the conditions required for successful business. To this end, the report's recommendation, although addressed to the goal of attracting FDI, are also critical for creating the proper conditions for local investors to enter the identified niches.

vii. The report proposes that Paraguay can become competitive in attracting four different kinds of FDI, providing that the necessary actions are taken. The four are:

Labor-Intensive Manufacturing

Energy-Intensive Processing

Agro-Industrial Processing

Privatization of State-Owned Firms

viii. For each opportunity, the report provides evidence supporting the contention that Paraguay could become competitive in this area. It also enumerates the reforms that would be necessary for the country to capitalize on its potential. Specifically, to attract FDI into these pursuits, the report recommends:

1. To increase the number of people with modern vocational and business skills for labor-intensive manufacturing, the Government should facilitate on-the-job training, expand private training institutions, improve public training programs, and strengthen basic primary and secondary education. In particular, the Government should review measures to encourage on-the-job training using international experience to identify effective ways to proceed.

2. To reduce labor market distortions, and to improve operational efficiency of businesses, the Government should reconsider the provisions of the Labor Code on job security and minimum wage. The policy direction should be away from Government intervention in micro decisions of firing workers and toward broader assistance with programs such as adequate unemployment benefits and retraining programs. The minimum wage should be allowed to decline in real terms.

3. To facilitate energy-intensive processing, it is necessary to reduce both uncertainty and transaction costs associated with lengthy negotiations on electricity price with ANDE. The Government should issue a supplementary decree or amend the Decree No 2,109 of 1994. The amendment should specify both the length of supply guarantee and formulae for price adjustment, and apply them across the board.

4. To build up a base for agro-processing, Paraguay needs to improve the quality control of raw and semi-processed materials, and to ensure the future supply of those inputs. While taking advantage of on-going studies done in forestry and agriculture, a task force, including private firms, should analyze

comprehensively how various types of disincentives are weakening the base for agro-processing.

5. To successfully launch privatization, and thus to generate promotional effects on the general investment climate, the Government should avoid unnecessary delay, unclear decision criteria, and undue discrimination against one type of buyer over another in the privatization process. Such subjects as labor redundancy and corporate governance should be handled carefully, since those elements of privatization significantly affect the interest of foreign buyers and the outcome of restructuring.

ix. Following identification and discussion of these specific investment opportunities, the report addresses several general obstacles that are impeding export-oriented FDI. These are: problems in corporate taxation, weaknesses in infrastructure, remaining red tape, limitations on local financing, slowness of legal proceedings, and the need to improve investment promotion. The following recommendations are offered to rectify these problems:

1. To make the overall corporate tax regime more attractive without unnecessarily reducing public revenues, the Government could lengthen loss carry forward, conclude bilateral double taxation agreements with key countries, and reduce the withholding tax on interest payments. Further, Paraguay could move, within a couple of years or so, from the current tax holiday regime, to a more uniform two-tier corporate tax system, involving a lower corporate profit tax and a higher withholding tax applied on distributed profits both in Paraguay and abroad. If the Government so desires, very selective, performance-based incentives may be introduced into the universal tax regime for vocational training and/or exporting.

2. To improve infrastructure, and reduce, most importantly, the cost of transport, the Government should review existing legal bottlenecks to private provision of infrastructure, utilize such concession schemes as BOT and BOO, and develop a modern regulatory framework for private sector provision of infrastructure.

3. To make the business environment more open, and thus to improve Paraguay's image as a modern business center, the Government should continue to reduce red tape affecting business start-up, domestic operations, and trading.

4. To improve access to medium- and long-term lending in the country, the Government should continue the on-going financial sector reforms. For private firms to take advantage of foreign banks operating in the country, information disclosure requirements, for example, should be strengthened.

5. To strengthen investors' confidence in the law enforcement mechanisms, while modernizing the formal judicial system, the Government should review the ways to make use of domestic and international arbitration as a complementary commercial dispute settlement mechanism.

6. To engage in more cost-effective promotion, the Government should place more weight on the promotion of export-oriented investment than on export promotion of what Paraguay already produces. The Government should target the secondary sector in general and processing industries in particular. Geographically, the MERCOSUR countries and offices of extra-regional investors located in the region should be priority targets.

x. Based on the general success of reforms to date, the Government should be able to take on and meet the challenge of making Paraguay competitive for attracting export-oriented FDI. The future will not automatically be easy, given the scope of economic adjustment that MERCOSUR will require, but the Government will have in its hand a strategic plan that can provide the basis for informed decision-making and, with a little luck, one that should bring eventual success.

Chapter I. General Strategic Vision: Developing Paraguay Into An Export Platform For MERCOSUR And Beyond

A. Recent Developments

1. In Paraguay, both in the Government and in business circles, there is a general consensus that foreign investment could play an important role in modernizing and integrating the country into regional and world markets. Nonetheless, it is not yet clear how Paraguay should develop its niche in the new regional and global economic environment, and how FDI could be used strategically as part of the country's long- and medium-term developmental objectives. Nor is it yet clear what policies should be stressed to attract the types of FDI that Paraguay needs most and could realistically expect to attract.

2. For several years, Paraguay has been making significant progress in developing a framework for an open modern economy, and is beginning to attract FDI mainly in the secondary sector, much of it from surrounding MERCOSUR countries.

3. According to a survey conducted by the Central Bank of Paraguay, the inflow of FDI increased substantially between 1991 and 1993, albeit from a very small base. The FDI inflow in 1990 was estimated to be US$14.4 million. It increased to US$38.7 million in 1991, and further to US$72.8 million in 1992.[1] If one adds reinvested profits, capital increase and advances/loans from foreign direct investors, the figures become US$71.0 for 1990, US$80.9 for 1991, and US$117.1 for 1992.

4. The survey shows that in 1992 20% of the realized FDI inflow was for the primary sector, 70% for the secondary sector, and 10% for the tertiary sector. Between 1990 and 1992, the FDI inflow in the primary sector declined from US$55.9 million to US$23.0 million; whereas that in the secondary sector rose from US$14.3 million to US$82.3 million, and that in the tertiary sector rose from US$0.9 million to US$11.8 million. Within the secondary sector the largest amount of FDI went into such subgroups as food processing, plastic and rubber and other chemical products. Within the tertiary sector, finance, insurance, communications and transportation attracted FDI. Although it is difficult to know whether this is a long-term trend, it seems to represent an opening for growth in the secondary sector, led by foreign investments.

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[1] FDI for 1993 is said to have declined somewhat, judging by the reduced level of project approvals for the tax incentives covered under Law 60/90. Some observers attribute this decline to the uncertainties associated with the Presidential election of that year.

5. The Ministry of Industry and Commerce has a data base on project approvals for tax incentives.[2] Between 1989 and 1993, the Ministry approved 335 projects, either joint ventures or wholly foreign-owned operations. According to the Ministry's records, in cumulative terms starting from 1989, Brazil has invested the largest amount (about US$176 million), followed by Argentina (about US$70 million). The second tier of investors included Italy (US$14 million), USA (US$13 million), France (US$10 million), UK (US$8 million), and Germany (US$7 million).[3] In terms of the number of projects, Argentina becomes the first (86 projects), Brazil the second (46 projects), followed by Italy (29), USA (25), France (21), Spain (20), Germany (16), and Peru (15).

6. The same records show that, on average, the total size of projects was US$1.36 million, while the average foreign capital contribution to those projects was US$0.62 million. Brazilian investments were the largest on average (US$3.83 million). The UK also made relatively large investments (US$1.19 million). The Argentines tended to make much smaller investments (US$0.81 million), so did the Americans (US$0.52 million), the Italians (US$0.49 million), the French (US$0.48 million), and the Germans (US$0.44 million). Recently, the average size of the Brazilian investments has undoubtedly been influenced by a few large scale projects, especially the energy-intensive ones. Historically also, Brazilian investors engaged in relatively costly, large-scale projects, notably in the agrarian sector.

7. As for upcoming projects, a wide range of activities were being discussed or planned at the time of the FIAS field work, e.g., -- high voltage, energy intensive operations (industrial gases and ferro-alloys), processing activities using relatively low skilled labor (leather products and textiles), production of high value, low transport cost pharmaceutical products (enzymes), and processing of Paraguayan raw materials (soya milk and canola oil).

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[2] The records are based on the project proposals and feasibility studies submitted before undertaking projects. Foreign investors who did not apply for the tax holiday are not included in the analysis, although the Central Bank survey indicates that more than 90% of the FDI realized in 1991 and 1992 were receiving the tax incentives.

[3] It should be noted that some of these investments are made or represented by immigrants residing in Paraguay. The classification of national origin of investment is thus not sufficiently clear.

8. The interviews revealed both positive and negative sides of Paraguay's investment climate.[4] The perceived advantages of Paraguay were: macroeconomic stability, low cost of labor, energy and land, low effective tax rate, the ease of management derived from the cultural and linguistic commonalities or similarities, the central location within the MERCOSUR market, and the business-oriented new government. Of course, investors differed in emphasis. For instance, for Brazilian investors the cost of labor was not considered a significant advantage, but they considered macroeconomic stability and long-term cost of energy a very attractive factor.[5] For Argentine investors, most costs, including labor cost, were very attractive in Paraguay. One significant similarity among the different nationalities of investors was that there seemed to be a growing interest in Paraguay partly because of MERCOSUR, and partly because of the Government's positive attitude toward private business. In addition, the announcement about the privatization program was also drawing attention, particularly from international banks.

9. The negative views FIAS encountered centered on: the lack of local financing possibilities for prospective projects; the lack of supporting industries that makes it necessary to import the bulk of raw materials needed for processing; the difficulties of finding industrial sites with suitable business infrastructure; the difficulty of securing dependable, low cost transport year round; the need to import managerial and technical personnel and to train workers abroad; the perception of Paraguay as a backward country managed like a private club of insiders; and a lack of confidence in law enforcement mechanisms. For small- and medium-scale Argentine investors, the lack of local finance seemed to be a crucial issue, strongly influencing the investment decision itself as well as the size of the project; whereas Brazilian investors could obtain some financing from Brazilian banks and Brazilian government programs. For South American investors, transaction costs incurred for business entry in Paraguay are normally at an acceptable level; while investors from outside the region tended to

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[4] FIAS conducted about 90 field interviews, mainly in Asuncion, Sao Paulo, and Buenos Aires. The sample included 49 private companies and associations, from Brazil, Argentina and other countries. The interviews were qualitative. No quantitative survey was done to arrive at aggregate data. The sample is biased in the sense that FIAS mainly contacted companies that had already shown some interest in investing in Paraguay and the ones that had already established operations in the country.

[5] Although market wages in Brazil and Paraguay differ, due to a lack of quality labor in Paraguay, and thus the need to train people or to import skilled personnel, Brazilian interviewees felt the real cost of labor can become close to that in Brazil, particularly for companies using relatively modern technology and management practice.

complain much more about legal procedures, red tape, and law enforcement mechanisms.

B. What Can Be Done?

10. Paraguay should aim at attracting export-oriented FDI and becoming an export-platform within the evolving regional market. Almost all analyses agree that due to the small size of its domestic market, Paraguay's future economic development will largely depend on the expansion of exports. Many also argue that the present dependence on low-value-added commodity exports (notably cotton fiber and soybeans) should be changed. Foreign investors can make a vital contribution to such economic transformation. FDI can improve access to regional and international markets, bring in new products, technology, risk capital and business practices, and provide an effective vehicle for skill formation.

11. As has been observed in success stories in East Asia's small economies, a clear strategic focus is needed to catapult a country into the front ranks of attracting FDI. They pursued export-oriented development strategies, developing and maintaining key elements of the investment environment which build competitiveness in exporting, consciously taking advantage of foreign direct investment, and building upon such existing advantages as initially low cost but highly educated labor force.[6]

12. Attracting a significant amount of export-oriented FDI is not an easy task. First, as the basic condition for private sector development in general, macroeconomic stability in terms of inflation and real interest rates should be ensured. Predictable price movements and interest rates give an important assurance about the overall investment environment, lower uncertainty, and are conducive to longer-term investment decisions. Second, to encourage exports, the exchange rate should not be overvalued, and sharp swings of the real exchange rate must be avoided. Competitive and stable real exchange rates maintained over a long period of time make a significant difference to export expansion. Third, export-oriented foreign investors are highly mobile and need to be treated well. Since they do not enter a country to sell their products to its domestic market, they have a lot of freedom in selecting an investment site. Fourth, the competition among countries for export-oriented FDI is intense. Both through private and public efforts, many countries in the world are actively competing to attract such foreign investors. Fifth, because their products need to compete on tough global markets, those investors are highly conscious of cost and quality. The country needs to meet their high standards if it desires to attract much export-oriented FDI.

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[6] See The East Asian Miracle: Economic Growth and Public Policy, The World Bank, 1993.

13. To meet investors' needs to minimize production and other operating costs, the country should try to offer low cost inputs. They can be low cost in terms of unit labor cost adjusted for productivity, service charges for transport facilities, unit energy cost, financial and insurance charges, overall tax burden, and business transaction costs arising from various legal procedures. The country should also ensure that the quality of inputs is competitive. The energy supply should be stable. The transport network should be efficient and dependable. The locally available raw materials need to be reliable in terms of supply and quality control.

14. In developing an overall framework for export-oriented private investment, Paraguay is basically on the right track. Since the end of the 1980's, Paraguay has made commendable progress in modernizing the economy. In February 1989, the exchange rate was unified. Since then a dirty float regime has been working reasonably well. The Central Bank has largely maintained the real exchange rate constant between mid-1991 and mid-1994, letting it fluctuate within a 5-10% range. Since 1990, the tax regime has been going through a rapid modernization, including the introduction of VAT, imposition of taxation on state owned enterprises (SOEs), and various administrative changes. Between 1989 and 1992, the Government reduced the amount of external debt from US$2.6 billion to US$1.6 billion by repurchasing official and commercial bank debts. Despite these difficult reforms implemented in a relatively short time period, in terms of the rate of inflation, Paraguay has maintained the best track record within MERCOSUR.[7] Except for 1990, when it went up to 44% per annum, Paraguay has kept its annual inflation rate around or below 20%. The year-average CPI in 1993 was 18.3%. As of mid-1994, the Central Bank is trying to meet its target rate of 15%.

15. Paraguay has long been known as an entrepot mainly for smuggling, and has had *de facto* relatively open frontiers.[8] The formal trade regime had been characterized by a number of special regimes, surcharges, and non-tariff barriers including trade prohibitions; however, the situation has been changing. The tariff reductions within MERCOSUR have been implemented as scheduled. Further, the modernization of the trade regime, with simple import tariff structure, zero export tax, and 0-10% import duties, has established an open trade regime.

16. While this broad macro-economic framework establishes many of the necessary conditions for attracting export-oriented FDI, it is not sufficient. Paraguay must also

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[7] For instance, in 1991 the inflation rates were 11.8% in Paraguay, 81.4% in Uruguay, 84% in Argentina and 458.6% in Brazil. In 1992, the rates were 17.8% in Paraguay, 58.9% in Uruguay, 17.5% in Argentina and 1,142.0% in Brazil.

[8] At the beginning of the 1990s, the size of unregistered trade was said to be at about one-third of the total registered trade.

focus remedial attention on a number of sector-specific problems that are impeding investment, as well as redress some general issues that remain problematic. In this vein, Chapter II identifies four possibilities for foreign investment and highlights the steps that the Government will need to take in order to remove obstacles to these opportunities. Chapter III then focuses attention on several of the broad problems that already are under attack from government reforms, but which must be solved in order for the foreign investors to choose Paraguay as a platform for export-oriented FDI.

Chapter II. Strategic Opportunities: Developing Niches Of Competitive Strength

A. Labor-Intensive Manufacturing

17. Paraguay has the opportunity to develop labor-intensive manufacturing for export to the regional market and perhaps beyond. While Paraguay may never be directly competitive with truly low-cost sites, such as ones found in South and South East Asia, its cost advantages within the region can make it successful in attracting labor-intensive investments for the MERCOSUR context.

18. Today, as shown in Table I, on average, market rates (excluding training costs) for low-skilled Paraguayan workers are by far the least costly among the five regional countries in terms of labor cost per month (gross wage and other payments by employers, divided by the number of statutory working days) and of adjusted labor costs per month (gross wage and other payments by employers divided by actual days worked). As FIAS's interviews indicated, certain types of investors looking for a pool of cheap, unskilled labor, find Paraguayan workers attractive. This category included medium- and small-size Argentine firms using labor intensive technology. They produce for home markets and/or exports, and have been suffering from high local operating costs and the strong Argentine peso in their home country.

Table I - Market Cost of Labor

	Labor cost per month in US$	Adjusted labor cost per month in US$
Paraguay	219	242
Argentina	922	1005
Brazil	561	626
Uruguay	833	901
Chile	751	825

1992 Data provided by CEPPRO

19. Moreover, actual and potential investors considered Paraguayan workers to be flexible and easy to work with. The low level of absenteeism, as shown in Table II and as reflected in its labor costs of time effectively worked, indicates relatively good

labor relationship in the country.[9] In addition, regional investors both from Brazil and Argentina considered Paraguay attractive because of cultural and language similarities to their respective home countries.

Table II - Rate of Absenteeism

	Absenteeism
Paraguay	3.5%
Argentina	10.1%
Brazil	4.7%
Uruguay	7.8%
Chile	2.8%

1992 data provided by CEPPRO

20. Despite these advantages, the Government still has to work on three aspects of Paraguay's labor force to attract more FDI: quality of labor, employment security and minimum wage.

21. The most serious disadvantage is the generally low labor quality and a lack of people with skills for a modern economy. In 1992, less than 30% of the population received education beyond primary school, by far the lowest in MERCOSUR.[10] In the same year, only 6% of post-primary school students took programs in commerce, and only 1% in technical training in formal institutions. There is a critical shortage of qualified engineers, managers, accountants, bankers, etc. This weakness negatively affects Paraguay's attractiveness not only to labor intensive industries, but also to all the other categories of industries.

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[9] In 1991, only about 2 percent of Paraguayan workers were unionized. In recent months, however, the traditionally good labor relationship deteriorated somewhat in the beginning of 1994. In May 1994, the first general strike in 36 years was held. It remains to be seen how the political and economic liberalization will affect Paraguay's labor relationship.

[10] The comparative numbers were about 69% in Argentina (1987), 39% in Brazil (1990), and 84% in Uruguay (1991).

22. This problem makes Paraguay very expensive for potential investors, especially those who require relatively high-level skills, modern management and financial practice, and new technology. For instance, according to one study, in vegetable oil, milling and beverages production, Paraguay workers earn very low wages among the MERCOSUR countries. But their low level of productivity substantially raises labor cost per output in those sectors.[11] Many foreign investors operating in Paraguay have to send employees abroad, typically to headquarters, for intensive training, especially at the time of business start-up. Many middle- and high-level managers and professionals in modern firms have to be brought in to Paraguay from their home countries, owing to a sheer lack of people with modern managerial and financial skills. This situation makes operations in Paraguay expensive for many investors, diminishing its advantage as a country of low wages. Moreover the situation discourages types of industries that tend to bring in high technology and add high value to the economy.[12]

23. There are many ways to increase the number of people with modern vocational and business skills: facilitating on-the-job training, expanding private training institutions, improving public training programs, and strengthening basic primary and secondary education.[13] It is beyond the scope of this study to discuss all the aspects of vocational training. Suffice it to touch upon a few areas.

24. First, experience shows that on-the-job training in the private sector can be the most effective and efficient way to develop the skills of the work force. In the best cases, employers train workers as quickly as possible for existing jobs. Costs are low compared with training before employment, and trained workers are placed automatically in jobs that use their skills. Larger employers often have the technology, and their supervisors have the expertise, to train in newly emerging skills.

25. Economic and social policies should be set in such a way that they do not distort the incentives provided to employers and individuals to invest in skills development. Distortions take a variety of forms. For example, policies that guarantee permanent public employment artificially increase the demand for the formal education and training qualifications that are required for entry to public

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[11] See Costos Laborales en el Mercosur: Comparacion de los Costos Laborales Directos, Fundacion de Investigaciones Economicas Latinoamericanas (FIEL), 1992.

[12] Initial costs incurred by new investors on human resources can be substantial. One high-tech joint-venture in Chile, at the time of business start-up, incurred training expenses equal to about 80% of annual payroll expenditures.

[13] This discussion on the means to develop vocational skills is based on a policy study done by the World Bank, Vocational and Technical Education and Training, 1991.

sector jobs. Government intervention in setting wages can result in artificial prices for different skills that do not necessarily reflect their value in production. As will be discussed below, Paraguay's labor market is distorted by its high minimum wage. The new Labor Code is a step forward in the sense that employers may now pay lower "training wages" of no less than 60% of the minimum wage, normally up to one year (Articles 105-118). Apart from this, however, no special compensating measure exists for on-the-job training. Training costs incurred domestically are tax deductible as are other operating expenses, but it seems that tax authorities do not consider overseas training expenses as deductible.

26. When it is not easy to change such labor market distortions quickly, as a second-best, transitional options to adjust for the effects of continuing distortions, compensatory measures could be introduced. The measures may include, for example, partial public subsidies to compensate for high training costs (incurred both in Paraguay and abroad) to employers. Several countries, such as Brazil, Malaysia, Fiji, and the Philippines, allow tax deduction of training expenses over and above the actual costs of training. For example, in Brazil, companies may deduct up to double the expenditures on approved training, up to a maximum of 10% of tax liability.

27. Further, the Singaporean Government has successfully used a reimbursement program to stimulate training. In the beginning of the 1980s, Singapore established a Skills Development Fund with a levy on the wages of unskilled workers to upgrade the work force through training grants to firms. By 1985, the Fund had awarded grants to 23,000 applicants. Training reached 240,000 workers, or 21 percent of the labor force.[14]

28. The second area is vocational training in private institutions. Private institutions tend to have several advantages over public ones. Private training institutions must function in the marketplace and be adept at changing enrollments and curricula to fit with the employment opportunities available for graduates. Freedom from civil service salary regulations and ministry of education curriculum

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[14] In the first two years, efforts were focused on creating awareness of the fund among employers, with ad hoc reimbursement of approved courses. In the second stage, priority was given to in-plant training, and reimbursement increased to 90% of costs as an additional incentive. The third stage encouraged the development of corporate training plans by paying grants in advance of expenses, thus reducing interest costs to firms. Some countries have opted for measures more directly supported by public expenditures. To lower set-up costs of new investments, Ireland offers one-time training grants covering 100% of agreed training needs. Some of the US states also offer generous inducement packages including the provision of tailor-made, pre-employment training services offered free to new investors.

control gives private institutions more flexibility to respond to changing demands for skills.

29. Private sector institutions account for only about 20% of the total educational sector in Paraguay. In 1993, about twenty-five, mostly small private institutions, were offering degree and short-term courses mainly in computers, management and business training. It seems that there are no significant barriers such as control on tuition fees, salaries and curricula; but the Government is not facilitating private sector development of vocational institutions, either. The Government should encourage development of private training programs and institutions. For instance, enterprise associations have been successful in establishing training operations as well as technical and managerial assistance services in many countries. The Government can help establish such operations by offering technical assistance and facilitating regional and extra-regional collaboration among similar entities.

30. Public programs also provide vocational training. Paraguay has about 30 vocational training institutions supported by the Government and several donors. Some programs, for instance certain industrial extension services offered by the Ministry of Industry and Commerce, and the Servicio Nacional de Promocion Profesional (SNPP), are said to be of reasonably good quality.[15] Existing strengths should certainly be developed.

31. Underlying all vocational training is the crucial need for higher quality basic and secondary education. As demonstrated in the successful cases in Asian exporting economies, those countries built up high standards in primary and secondary education. The high quality basic education in turn provided a solid basis for further training in specific functional areas need in modern industries. The Government should ensure that a much larger proportion of the population receives good quality, primary- and secondary-level education.

32. Another disadvantage of Paraguay's labor situation relates to the issue of job security (stabilidad laboral). The current Labor Code (Law no. 213/93) assures job security for those who have been with a single employer for more than ten years (Articles 94-104). Essentially, an employer can fire an employee who has been with a firm for that period of time only under three conditions. First, the court approves dismissal when the employer provides sufficient evidence of employee malfeasance. In this case, no indemnity is paid to the employee. The second condition is where business is proven to be in serious trouble involving bankruptcy or long-term reduction in operation. If the Labor Court grants an approval on this condition, the employer can fire the employee, as long as the former pays indemnity. If Article 82

[15] SNPP is supported by a 1% levy on the payroll of enterprises. SNPP funds training activities both in the public and private sector.

and 99 are applied, the indemnity would be equivalent to 30 daily salaries for each year of service, in addition to the total salary owed to the employee during the processing of the case in court. The sum would not exceed an amount equivalent to a two-year salary.[16] The last condition is where the employee voluntarily chooses to leave the firm. In this case, as well, employer would pay the same indemnity as in the second case.

33. It seems that the Labor Court has often made favorable rulings for employees. For instance, the Court has ruled that an employer cannot fire someone halfway into his ninth year without the approval of the Court, and, in at least a few cases, this limitation has been extended into an employee's eighth year.

34. While it is important to safeguard workers' basic rights, excessive labor security decreases operational efficiency and profitability of business. In the long-run, furthermore, this type of employment protection can be self-defeating, because some investors will use fewer employees and substitute for them non-labor inputs to avoid future complications. Or, they could decide to invest elsewhere, because export-oriented investors in labor-intensive processing industries normally have a lot of freedom in choosing a production site that offers flexible labor markets. Additionally, as will be discussed further below, under privatization, the attractiveness of SOEs to be sold to new investors diminishes, if it is very difficult and/or costly to reduce the work force.

35. The Government should reconsider the provisions of the Labor Code on job security. The policy direction should be away from Government intervention in micro decision of firing workers and toward broader assistance with programs like adequate unemployment benefits and retraining programs. There is certainly a role for courts in cases of unfair dismissal (e.g., breaking employment contracts). But the courts should not get involved each time an employee with a long-term tenure is dismissed.

36. The third fundamental obstacle to labor-intensive manufacturing relates to the minimum wage. Paraguay's legal minimum wage has been set very high as compared to the other MERCOSUR countries. In mid-1991, the legal minimum wage in

[16] Article 79 provides for a different set of rules for indemnities paid to different classes of workers, making the indemnity rules rather contradictory. Article 79 defines indemnities for the following "justifiable" cases: death of employees, liquidation, depletion of raw materials, and extra-ordinary business conditions beyond employers' control. In such cases, employees with 1-5 year of service would receive a one-month salary, those with 5-10 years a two-month salary, and those with more than 10 years a three-month salary.

Argentina was equivalent to US$97. When employers' social contributions were included, the rate was US$129. In Uruguay, the respective figures were US$80 and US$94, and in Brazil US$80 and US$108. In Paraguay, the figures were US$185 and US$265.[17] In early 1993, the minimum official wage in Paraguay was 300,000 Guaranies, equivalent to US$175, compared to US$140 in Argentina. In Paraguay, the real value of the minimum wage has been allowed to decline through devaluation by approximately 15 percent during the last five years, but it is said to remain above the market wage actually paid to a significant portion of the labor force both in the private sector and the public sector.

37. This situation presents a problem to foreign investors. With the generally low labor productivity in Paraguay, it may work against attracting more FDI in labor intensive industries. Normally, highly visible foreign investors need to abide by the law and pay at least the minimum wage, even if the Government does not always enforce the legal minimum wage. For some types of export-oriented investors, the cost of labor accounts for a substantial portion of the total operating cost. Since they tend to compete on the world markets with a very thin profit margin, uncompetitive wages seriously affect their investment decision.

38. In addition, more generally, a high minimum wage tends to create fewer jobs at a high price. It also drives people into the informal labor market where neither social security benefit nor legal protection is available.

39. The Labor Code requires that there be a minimum wage (Article 249), but allows for taking market wages (and labor productivity) into account in determining that wage (Article 250). The Code states that the minimum wage can vary for different geographical areas, and can take account of economic and financial considerations (Article 255).

40. It is recommended that the Economic Council (Equipo Economico) and the National Council of Minimum Wages (Consejo Nacional de Salarios) evaluate the economic consequences of having a high minimum wage.[18] The minimum wage

[17] The social security and other taxes paid by employers are 16.5% of gross wage in Paraguay, 17.5% in Uruguay, 33% in Argentina, 35.2% in Brazil.

[18] The Equipo Economico periodically adjusts the minimum wage taking into account the recommendations made by the Consejo Nacional de Salarios. The Equipo comprises the Ministers of Finance, Commerce & Industry, and Agriculture and the President of the Central Bank. The Consejo Nacional de Salarios includes representatives of the Central Bank, the Ministries of Industry & Commerce and Public Health, worker and business associations. The Consejo meets whenever cumulative inflation exceeds 10 percent.

should at least be allowed to decline in real terms until it reaches a reasonable level relative to the market wage. Also, employer contributions over the minimum wage (currently at 16.5% of gross wage) should be examined for possible reductions. Finally, the Government could consider creating a separate category of workers. For instance, the Government could apply the minimum wage only to workers with five years of directly relevant job experience. This measure would officially change the concept to a minimum wage for workers with a certain skill level, allowing firms to hire untrained people at a lower wage.[19]

B. Energy-Intensive Processing

41. One of Paraguay's strengths lies in the current and future supply of a large amount of hydroelectric energy. Paraguay has the right to half of the power generated in Itaipu and Yacyreta. The power generation capacity of these two complexes vastly exceeds Paraguay's current and projected energy consumption. The Itaipu dam produces 12,600,000/kwh. Paraguay only consumes about one-tenth of its power entitlement from the Itaipu. Further, when completed, the Yacyreta dam is projected to produce more than 17,550,000/kwh.

42. As shown in Table III, Paraguay has a significant advantage over its neighbors. For average electricity users in different categories, all the rates are much higher in the neighboring countries, with the exception of industrial use rates in Brazil.[20]

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[19] For many industries, the practice of paying special trainee wages only up to one year is too limited. The allowable duration of traineeship could be extended to create the classification of semi-skilled workers, with less than five years' experience, who would be exempt from the minimum wage.

[20] According to studies done by MERCOSUR Sub-Group No. 9, Electricity prices in Paraguay and Uruguay are determined by a single government entity - ANDE in Paraguay and UTE in Uruguay - for the entire country. In the case of Brazil and Argentina, electricity rates are set by regional entities - 9 in Argentina and 24 in Brazil - and vary accordingly. For instance, industrial rates in Buenos Aires as of February 1, 1993 averaged US$0.106/kwh, but US$0.142/kwh in Cordoba. A similar variation can also be observed in Brazil. The rate for a medium-sized industrial consumer averaged US$0.045/kwh in Curitiba, $US0.058/kwh in Sao Paulo, and US$ 0.062/kwh in Belo Horizonte.

Table III - Average Electricity Prices (US$/kwh) - March 1994

Sector	Argentina	Brazil	Paraguay	Uruguay
Residential	0.119	0.076	0.049	0.112
Commercial	0.211	0.095	0.054	0.118
Industrial	0.183	0.047	0.044	0.072

Source: OLADE

43. Moreover, a preferential price schedule for high voltage industrial energy has been established in the Decree No. 2109 of January 1994. The prices are applied in such energy-intensive industries as metallurgical and electrochemical industries. The Government, through ANDE (the Administracion Nacional de Electricidad), guarantees tariffs between the Guarani equivalent of US$0.021/kwh and US$0.0252/kwh. The tariff varies depending on the voltage and on whether or not the access to power supply continues through the peak hours between 5 and 8 p.m (Article 1).

44. Many interviewees were aware of Paraguay's advantage as a power generator. Owing to a widespread discretionary practice, large companies seem to get preferential treatments also in Brazil. Anecdotal evidence suggests that the current cost of energy for such companies approach that in Paraguay. According to our interviews, however, Brazilian investors consider that, due to Brazil's under-investment in energy in the 1980's, their energy price will drastically increase in several years, and that Paraguay will offer a much lower price in the medium- and the long-run. Currently, two major Brazilian investments in the energy-intensive sector are underway, one in industrial gas production and the other in ferro-alloys. Both of them are taking advantage of preferential pricing under the new Decree.

45. The Decree shows the Government's commitment to attract investments in energy-intensive sectors. The present legal framework is much better than the previous situation where no yardstick existed on the price to be paid by high-voltage, high-volume industrial users. Nonetheless, the Decree has three major weaknesses from the point of view of potential investors. Due to these weaknesses, too many decisions are left to negotiations and to be specified case-by-case in individual contracts signed between investors and ANDE.

46. First, the recent contracts signed for two Brazilian investments are said to last for 10-20 years; but there is no guarantee that another investor would obtain the same length of guarantee on the energy supply. Second, according to Article 2, the

tariffs shall be adjusted in accordance with the variations in ANDE's purchase cost, as well as international economic indicators.[21] Mathematical formulae will be set out in individual contracts, but there is no public knowledge as to what formulae would be applied in individual contracts. This uncertainty as to future price of energy weakens Paraguay's perceived advantage as a reliable supplier of cheap energy.

47. Third, the Decree leaves it unclear who will be given priority in getting the supply guarantee in future. Article 1 sets ceilings as to the volume of power to be made available under this Decree for each category.[22] Article 5 seems to indicate that investors who have obtained tax holidays through Law 60/90 would be given priority. Even though those ceilings will not be reached in the foreseeable future, the requirement that the investor obtain tax exemptions creates an unnecessary step for obtaining an ANDE contract. Further, the Decree does not give any clear indication about the order under which ANDE would give out contracts. It only indicates that beneficiaries of Law 60/90 would be given preference over non-beneficiaries.

48. In order to reduce both uncertainty and transaction costs associated with lengthy negotiations required under the current system, the Government should issue a supplementary decree or amend the Decree No. 2,109. In improving the Decree, the Government should specify both the length of supply guarantee and formulae for price adjustment, and apply them across-the-board. Moreover, as long as investors' energy use patterns qualify, an ANDE contract should be given on a first-come-first-served basis. Preference based on a tax holiday under Law 60/90 should be eliminated from the Decree.

C. Agro-Processing

49. Many analyses indicate that agro-processing would be a major potential area for private investments in Paraguay. For instance, one study shows that relative to the other MERCOSUR countries, Paraguay may have comparative advantage in such semi-manufactured products as essential oils, veneer, plywood, tea and mate.[23] Some argue that there are diversification possibilities in such processed products as

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[21] In 1994, ANDE's purchase cost of energy from the Itaipu complex is US$ 0.016/kwh.

[22] 90,000 kilowatts for non-peak hour users and 100,000 kilowatts for continuous users including peak hours.

[23] This is based on a revealed comparative advantage analysis, which only gives a general idea of Paraguay's comparative advantage in products concerned, among the MERCOSUR members. See The World Bank Report No. 10902-PA, Paraguay: Mercosur and Paraguay's Growth Prospects, January, 1993, pp.23-25.

essential oils, nuts, spices, citrus juice concentrates, meat products, fruits and vegetable products, fresh dairy products, furniture, parquet, and pulp, either for the regional or for the world market.

50. Traditionally, cattle grazing and agricultural products have been the major areas of foreign investment in Paraguay. A large part of agricultural land in Eastern Paraguay (some say about 40%) is either Brazilian owned or held in joint venture with Brazilians. There have been smaller Argentine, US and German investments. At the time of its mission, FIAS met quite a few investors considering investments in agro-industries. Their interests ranged from such established areas as soybean processing for the MERCOSUR markets to organic rice products for European and North American markets.

51. According to the World Bank estimates, the agro-industrial sector grew significantly during the 1980s. In 1991 the sector accounted for 76% of the value of industrial production. Lumber processing grew, at 7.2% per annum, the cotton sector at 11.5%, the beverage sector at 8.3%, and tobacco processing at 2.0%.[24] Within the agro-industrial sector, food products grew at 3.5% per annum.[25] The leather processing is the only sector with negative growth. Its share in total industrial products dropped from 7.1% in the mid-70s to 4.3% in the beginning of 1991.

52. Despite positive growth rates in most of those activities, of the share of exports of processed goods decreased, mainly because of a faster export growth in primary products such as soybeans and peanuts. During the 1980s, the share of semi-processed goods (e.g., cotton fiber and sawn lumber) declined from 60% to 50%. The share of processed products (e.g., vegetable oils, sugar, and leather products) declined from 16% to 13%.

53. There are several fundamental problems limiting the attraction of Paraguay to export-oriented foreign investors interested in agro-processing.

54. The first area of serious concern relates to the quality control of inputs. Paraguay's attraction for export-oriented processing firms would increase if there was a good base offering a network of local suppliers offering high-quality and low-cost inputs. For instance, FIAS met with two small-scale Argentine leather goods firms planning to relocate some operations to Paraguay. Due to the low quality of processed leather materials available in Paraguay, the Argentine firms would have to

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[24] The cotton sector includes cotton fiber, yarns and fabrics.

[25] The food products include meat products, fruit and vegetable products, dairy products, vegetable oil, milling products, sugar and its derivatives and manufacturing of food such as starch, flour, coffee and animal feed.

import almost all leather inputs from Argentina. This quality problem results both from the careless manner in which cattle is branded and from the fact that cattle is left to age much longer in Paraguay than in Argentina and Uruguay. Other industries such as meat processing, sugar-refining and cotton processing also suffer from the same kind of quality control problems.[26]

55. The second problem relates to reliability of the future supply of inputs. Paraguay has been experiencing rapid deforestation. For example, in the Eastern Region, the forests occupied 88,000 km^2 in 1945, 55,000 km^2 in 1976, and 33,000 km^2 in 1991. Limited reforestation is said to be taking place with eucalyptus and pine. But Paraguay's native hardwoods, such as cedar, guatambu, and peterby, are said to be diminishing rapidly. Despite the ban on export of logs, most trees are exported with minimal processing by smugglers. Under Paraguay's legislation, unused land is subject to expropriation for settlement purposes, and forest land is by definition considered underutilized.[27] Thus, landowners have deforested their land in order to convert it to pasture or cropland, thereby avoiding the increased threat of invasion or expropriation. This has contributed to wasteful logging practice where up to 90% of the forestry resources is discarded. Without a concerted effort to reverse this situation, Paraguay could run out of forestry resources in the near future. This trend is felt, for instance, in the production of tung oil whose output is said to be decreasing due to the shrinking availability of tung trees. Paraguay has also lost export markets for timber in Italy and Germany.

56. The third problem is exogenous, and one of the reasons why exporters of raw materials often compete successfully with processing industries for inputs (e.g., soybeans and cotton fiber). Although the MERCOSUR agreement may reduce the magnitude of this problem, protectionism abroad against processed goods makes it

[26] The meat industry seems to suffer from the incidence of hoof and mouth disease that prevents beef from entering US and most European markets. The sugar refining plants receive different varieties without adequate classification. The suppliers, typically small farmers, often send late varieties too early, or conversely early varieties too late, with consequent loss in quality. Although Paraguayan cotton fiber is of better than average quality, some foreign observers complained that it is difficult to procure a reliable supply of high quality cotton due to poor quality control.

[27] The Agrarian Reform Law no. 854, Article 1581, states that land is rationally exploited if permanent improvements such as agriculture and ranching amount to at least 50% of the fiscal value of the land. The existing fiscal value of land normally is very low, and thus it is easy to meet this criterion of permanent improvement.

more attractive to export raw materials.[28] For instance, the Netherlands has been by far the largest importer of Paraguayan goods outside MERCOSUR.[29] In 1992, Paraguay exported 61% of its unprocessed soybeans and 68% of its soybean meal, but only 6% of its soybean oil to the Netherlands. The Netherlands has an escalating tariff structure --- a 0% tariff on unprocessed soybean, a 7% tariff on soybean meal, and a 15% tariff on soybean oil --- which has undoubtedly influenced the pattern of Paraguay's export to that country.

57. Another set of problems stems from the generally weak industrial infrastructure of the country. Even when they exist, most local suppliers of semi-processed goods are undercapitalized, small, and technically obsolete. As a result, short of developing a whole chain of related industries at once, new investors would have to import most of their inputs. Moreover, many agro-industries tend to locate in the Central Region because of its advantages in terms of power supply, communications, services, labor, etc; while sources of raw materials are much more dispersed. The underdeveloped state of the infrastructure and resulting high transport costs further reduce profit margins.

58. The Government needs to analyze in a comprehensive manner how various types of disincentives are weakening the base for agro-processing. The problems in the agro-industrial sector are complex. Yet, this sector represents one of the greatest opportunities for Paraguay to attract export-oriented foreign investment.

59. The Government should create a task force of public officials, private company executives, and perhaps academics to quickly analyze the barriers to successful investments and to offer specific remedies. Some legal and policy issues, for instance the ones affecting rural land use and titling are being reviewed under the World Bank's Land Use Rationalization project. The task force should take advantage of such on-going work. Foreign companies should be invited to participate on the task force, including some of the large regional companies in Brazil, Argentina

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[28] There seem to be two other major reasons why processing industries often complain that exporters of raw materials buy up raw materials. First, exporters tend to have lower costs and quicker turnaround of the operating capital. Second, exporters tend to work closer to the producer than the industrialists in the sense that the former give credit to the producer and get the upper hand in the purchase of the products.

[29] In 1992, the largest importers of Paraguayan goods were: Brazil (27% of total Paraguayan exports), the Netherlands (21%), Argentina (10%), and USA (5%). In the same year, the largest exporters to Paraguay were: Brazil (21%), Argentina (16%), USA (14%), Japan (11%), UK (5%) and Germany (4%).

and Chile, which may not be operating in Paraguay but whose opinion would be useful.

60. Compensating measures should be designed carefully. Article 15 of Law 125/91, for example, allows for a reduction of the corporate income tax rate from 30% to 10% for reinvestment in forestry. However, such an isolated incentive measure seldom addresses the type of problems as described above. The task force should provide more comprehensive solutions, after a thorough study of ways to remove obstacles to agro-processing.

D. Privatization of State-Owned Firms

61. After a few years of political stalemate, the first round of privatization seems likely to begin. At the time of writing, the political decision generally appears more favorable to the effort than before.

62. By the time of the FIAS mission, the original privatization Law No. 126/91 had been modified. The new draft had been approved by the Lower House in December 1993, and was being submitted to the Upper House. The announcement of Paraguay's intention to privatize SOEs in international publications has drawn a large number of inquiries from banks and consulting firms abroad. As of June 1994, however, the Upper House and the Lower House were yet to settle disputes on such matters as preferential treatment of workers.

63. Seven entities have been announced for the first round of privatization efforts: LAPSA (airline), ACEPAR (steel mill), CAPASA (distillery and producer of gasahol), FLOMEPARSA (merchant fleet), Ferrocarril Central (railroad that runs between Asuncion and Encarnacion), FERTIPAR (producer of fertilizer), and the silos of the Ministry of Agriculture.

64. It is not yet clear how many foreign investors would be seriously interested in bidding for the projects included in the first round. Some Brazilian investors are said to be interested in CAPASA. ACEPAR may be attractive to some foreign buyers because it is a modern facility and has a cadre of steel workers who were trained in Brazil. LAPSA may be of some interest, although the market value of LAPSA would be low considering its serious financial condition and the cancellation of all LAP flights in March. The Ferrocarril Central will provide rail rights for the connection to Buenos Aires, although its assets need expensive upgrading.

65. Left for future privatization are: ANTELCO (telephone), ANDE (electricity), INC (cement), LATN (domestic airline), DINAC (airports), ANNP (river ports), PETROPAR (refinaries), IPS (social security institute) and CORPOSANA (water).

There seems to be quite a lot of foreign interest in purchasing especially ANTELCO, ANDE, and INC. Plans for future privatization were uncertain as of June 1994.[30]

66. Experience shows that a successful launch of privatization often generates positive promotion effects not only on privatization transactions but also on the foreign investment environment at large. Because of the announcement of privatization and recruitment of consultants and bankers, Paraguay is already attracting more attention abroad than before. Several observers aware of the announcement expressed their view that the country is finally starting to move ahead. Transparent and speedy privatization will create a positive image among the investor community. In contrast, further delay, protracted negotiations, unclear decision criteria, and undue discrimination would all contribute to a negative image of the country in general.

67. The new (draft) Law is an improvement over the former Law No. 126/91 in the sense that the new Law eliminates previous discrimination based on national origin of capital.[31] Generally, the new Law provides a workable framework. One good point is that, in valuation, market conditions will be given clear priority over other economic and social aspects (Article 17). Further, the bidding documents should contain provisions that will ensure transparency, widespread publicity and timely dissemination of information so as to promote privatization (Article 7).

68. However, there are two potential problems in the Law that may render Paraguay's privatization less attractive, unless some safeguard is put in the process. The first problem relates to labor redundancy. New investors would have to rationalize the enterprises if they are to be viable in the market. Such rationalization often entails politically and socially difficult labor reduction. Article 18 gives the Executive Power, if deemed necessary, the right to reduce the personnel of the SOEs before sales, with due compensation as specified in the Labor Code. However, it is not clear how that will actually be managed. As discussed earlier, the Labor Code contains strong employment guarantee provisions. Although labor reduction is

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[30] There have been indications in the press that some members of the Parliament are opposed to privatization of ANTELCO, ANDE, IPS, CORPOSANA and INC. In May, a bill prohibiting privatization of several SOEs was being discussed in the Parliament.

[31] Article 7 (c) of the Law No. 126/91 stated that national capital shall enjoy preference over any proposal presented by foreign capital in the evaluation and weighing of offers. Such preference, in the matter of prices, shall grant preference over national capital even when such prices are lower than others by 15 percent. Experience shows that such discrimination based on nationality often just induces bogus arrangements among national and foreign buyers.

allowed with due compensation in case of business closure and permanent reduction of labor force (Articles 79 and 99 of the Labor Code), it is not clear whether privatization would be interpreted to be covered by this provision. Official clarification about how the question of labor reduction will be handled would be useful for providing potential buyers with more assurance.

69. The second problem is that there is a danger that corporate governance by new owner-investors may become compromised. First, Article 4 grants the State the right to hold an unspecified amount of shares in privatized enterprises. Secondly, Articles 7, 9, 10, 11 and 12 set aside 10% of shares for employees and another 10% for those "directly involved" with the respective SOEs subject to privatization.[32] For these 20% of the shares, these preferred groups will be entitled to a 15% price reduction from the highest bid received for a particular SOE, and be allowed to pay in installments of up to 36 months. These two types of preferred groups will also be given a preferential treatment in winning an entire sale when their bids are at least as high as bids from outsiders. It is not yet clear to what extent this would affect individual privatization deals. While some degree of employee ownership may be workable, new buyers are wary of a situation where management control of a new firm may become ineffective due to strong insider interests. Such influence within the former SOEs would negatively affect investor interest. It could also slow down the pace of business turnaround. The Government should avoid maintaining shares in the privatized enterprises as much as possible. Golden shares should not be granted either to the Government or to the special beneficiaries.

70. Paraguay has an important set of assets in its state-owned companies. The decision to privatize these assets will send a strong signal to foreign investors about the country's willingness to develop its economy in the most efficient manner. This is an opportunity that should not be missed.

[32] "Sectors directly involved" with SOEs subject to privatization are defined as: (i) users of water, electric energy and communications services; (ii) individuals or juridical persons who have maintained regular contractual relations as suppliers of goods or services with the SOEs subject to privatization (Articles 3 and 10).

Chapter III. General Obstacles to Export-Oriented Investment

A. Corporate Taxation

71. One of the areas where the Government has already made significant progress is the tax regime. Although the whole culture of tax evasion and smuggling is slow to change, the tax reforms taking place in the past few years have laid a ground for a much simpler, modern tax structure. In the past, the tax regime was characterized by a high rate of tax evasion and corruption, weak tax administration and financial reporting, and numerous and duplicative taxes. In such an environment, relatively visible foreign investors had to pay taxes, and if they are unfamiliar with the local environment, they lost out because of unfair, non-transparent practices. With new changes including better tax administration, more private businesses will probably be willing to operate legally, as the transaction costs of illegal practice become closer to the tax payments.

72. As far as the magnitude of tax burden is concerned, Paraguay's tax regime has also become more competitive than before. The new general tax regime, even without special tax incentives, does not seem burdensome to foreign investors. The interviewees, especially the investors from the region, stated that Paraguay's overall tax regime is reasonable. Not only did the tax reforms reduce the number of taxes, they also lowered tax rates, indirect tax rates in particular. This is important because experience shows that the overall corporate tax burden is a more important variable to Paraguay than to countries that have large domestic markets and/or attractive resources. Much more than others, export-oriented companies, particularly the ones in processing industries, are concerned about every aspect of expenses, because the profit margin of those firms on the global market tends to be thin, and they generally can choose to locate in countries with low tax burdens.

73. The main features of Paraguay's recent tax reforms are contained in Law 125/91, the Decree No. 124 of 1993 and the MERCOSUR agreement. They are summarized as follows: (i) A VAT of 10% is applied to transactions on goods and services within Paraguay as well as on imports. The VAT is a consumption based type in the sense that the VAT paid for the equipment and inputs can be credited against the company's VAT liability on the sale of its output. (ii) Export duties and taxes have been abolished. The VAT is not applied on exports. (iii) Import duties are 0% for raw materials, 5% for equipment and 10% for final consumer goods.[33]

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[33] At present, the weighted import duty is about 6.5%. Exceptions apply for import duties on automobiles (15% and 20%), and for the so called "tourist trade" which is subject to a single rate of 8% combining import duty and a separate VAT. Some import and export prohibitions, however, remain. About 50 products are

(iv) At the end of 1994, the internal tariff within MERCOSUR will have been abolished.[34] (v) Most stamp taxes have been eliminated. (vi) A 30% corporate profit tax is applied across-the-board irrespective of the legal form of the company. (vii) The profit tax rate is reduced to 10% when the profits are reinvested for the installation, amplification or the renovation of fixed assets that are geared toward the production of manufactured goods and toward reforestation. (viii) Loss carry forward is allowed up to 3 years. (ix) Fixed assets and inventories can be revalued annually by the rate of inflation. (x) Depreciation allowances are 10 years for machinery, 4 years for computer equipment, 5 years for cars, and 10 years for urban buildings. (xi) A 5% withholding tax is applied to dividends remitted abroad, and 17.5% to interests and royalty payments abroad. In addition, along with these changes, the Government has been improving tax administration. It has focused on the introduction of the VAT, the overhaul of the customs administration, and a gradual extension of the tax base.[35]

74. So far, the tax reforms seem to have been working. For the first two months of 1994, the total tax revenues rose by about 74% in nominal terms over the same period in 1993. The VAT raised 25% more, customs duties 30% more, and the profit tax 211% more. The VAT has become the mainstay of tax revenues. In 1987, the sales tax accounted for 13.7% of the overall tax revenues; in 1993, its successor, the VAT, raised about 34.2% of the estimated tax revenues. Taxes on income and profits yielded 18.6% in 1987, and only 15.6% in 1993.

75. In relative terms, to potential foreign investors, Paraguay has a reasonable tax regime. As shown in Table VI, in terms of most key tax variables, Paraguay offers reasonable rates. Chile offers a 15% profit tax rate; but its withholding taxes are much higher than Paraguay's. Further, unlike Paraguay, on top of the taxes shown in the table, Brazil imposes a number of surcharges, and Argentina a tax on total assets. On the whole, Brazilian investors would clearly have tax advantages, if they relocate to Paraguay.

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prohibited for export, e.g., certain live animals, hides and skins, logs and scrap metal. About 125 products are prohibited for import, e.g., steel, cement, paper, vegetable oils and sugar.

[34] Some exemptions from that tariff reduction exist, but are scheduled to be phased out at the end of 1995.

[35] Two policies have been implemented in this aspect. One is the establishment of a special tax office to closely monitor large tax payers, or contribuyentes mayores. The other is the application of a 3% single tax, the tributo unico, on small enterprises. In lieu of the VAT and income tax, they pay this 3% tax on a presumptive income.

TABLE VI - Selected Tax Rates

	Paraguay	Argentina	Brazil	Chile	Mexico
profit tax, plus surcharges	30%	33%	about 45%	15%	35%
tax on dividend transferred to a country with no taxation treaty	5%	0%	15%	20% (same as domestic profit taking)	0%
tax on royalties transferred to a country with no taxation treaty	17.5%	10.5% to 24%	25%	35%	15-35%
tax on interest transferred to a country with no taxation treaty	17.5%	12%	25%	4 or 40%	15-35%
loss carry forward	3 years	5 years	4 years	indefinite	5 to 10 years
depreciation on building	10%	2%	4%	1 or 1.65%	5%
depreciation on machinery	10%	10%	10%	5 or 10%	10%
indexation on fixed assets and inventory	yes	no (used till 1992)	yes	yes	yes
tax holiday on corporate income	yes, widely used, 95% for approved projects	no (used till 1992)	limited, up to 100% for projects normally only in two regions	limited, different tax rates for forestry and special regions	limited, different tax rates, for agri-culture, timber, etc.
import duty on capital goods	5%	30%	40%	11%	11%

For Paraguay, data were collected during FIAS mission in March 1994. For other countries, data were compiled from various documents, e.g., Price Waterhouse Information Guides. The data for the other countries reflect the situation in 1992 and 1993, and may not be current.

76. There are three weaknesses in the general tax regime, from the point of view of foreign investors. One is that the loss carry forward of 3 years is relatively short by

regional and international standards. Lengthening of loss carry forward would be a visible change to investors, and would benefit slow-yielding investments.

77. The second weakness is that Paraguay today does not have double taxation agreements with key countries.[36] Such agreements allow investors in Paraguay to deduct taxes paid locally from their tax liability in their home countries Thus, Paraguay could reduce the tax burden on foreign investors by signing double taxation agreements with key partners.

78. The third weakness is that a 17.5% withholding tax on interest payments transferred abroad is high by international standards. Interest payments are a business expense and should not, in principle, be taxed. If not for interest payments made directly to parent firms abroad, interest payments made at least for third-party loans should be subject to a much lower withholding tax. Recently, many countries are lowering such a withholding tax to close to zero.

79. Another element of Paraguay's tax structure affecting private investors is the corporate tax holiday defined by Law 60/90. FIAS's previous report has already dealt with this tax holiday, especially with its administrative aspect. Nonetheless, it is useful here to analyze the effects of the tax incentives as they stand within the new tax regime.

80. The major benefits foreign investors have received under Law 60/90 are: (i) a 95% reduction of the corporate income tax rate for 5 years from the time of approval of the projects, bringing the nominal profit tax rate to 1.5%; (ii) a 100% exemption for 5 years from withholding taxes; (iii) a 100% exemption for 5 years from import duties levied on equipment, raw materials and parts used for the new investment; and (iv) a 50% reduction of the corporate income tax rate for the reinvested profits of the previous fiscal year, thereby reducing the tax rate to 15%, provided the reinvestment increases the paid-in capital by at least 30%.

81. Indeed, these tax exemptions drastically lower the overall tax burden on the early years of new projects, and private businesses always welcome lower taxes on profits. According to the Central Bank survey, about 90% of foreign investments realized in 1992 received the tax holiday approval. The interviews in Buenos Aires indicated that Law 60/90 has been used as a promotional tool. Some prospective investors view it as a concrete signal that Paraguay welcomes foreign private businesses. One interviewee stated that in his financial projections for a new project, the tax benefits would just compensate for extra transport costs he would have to incur by relocating to Paraguay. In addition, according to Government officials, the

[36] There is a double taxation agreement with Hungary. It seems that a few more are being negotiated.

duty exemption scheme originally helped investors cut through hitherto very cumbersome bureaucratic procedures for importing.

82. Notwithstanding these positive aspects of the Law, the benefits to new investors are not significant, and decreasing as the new reforms take effect. First, new projects do not normally generate a lot of profits in the first 5 years of operation. This makes the exemptions (i), (ii) and (iv) relatively unimportant. Secondly, although import duty exemptions must have originally had the largest effect, after the reforms, this benefit also has lost much significance. The exemptions from the 5% duty on equipment along with the 15-20% duty on automobiles remain the only attraction, because raw materials are now imported duty free by any importer. Moreover, equipment and automobiles from the MERCOSUR country are imported virtually duty free by anyone. Thirdly, the new tax reforms introduced a more favorable provision for reinvestment, rendering (iv) above less relevant to investors, because Article 15 of Law 125/91 establishes a 10% profit tax rate on reinvestment from a previous year's profits, without the requirement to increase the paid-in capital by a certain amount. Lastly, the Government efforts have reduced the red tape associated with trade. Though perhaps not as fast as export procedures, import procedures seem to have improved in the past few years.

83. As the previous report pointed out, tax holidays have many inherent problems that make them an ineffective tool to attract investment. The holidays tend to be redundant in the sense that they seldom induce additional investments. Because of many drawbacks, many countries in the world, e.g., Argentina, Hungary and Indonesia, have eliminated tax holidays.

84. First, tax holidays themselves constitute such a minor element within the overall FDI environment that they have little, if any, influence on most decisions to invest in a particular country. For investment decision-making in general, the overall tax burden is a less important variable than, for example, the market conditions for inputs and outputs, the foreign exchange regime, macroeconomic and political stability, various transaction costs associated with bureaucratic procedures, and business infrastructure. Tax holidays act more as a reward to investors who have already decided to come to Paraguay, rather than an inducement for new investments.

85. Second, most investors prefer a low, constant profit tax rate maintained for a long time period to a short-term tax holiday followed by a higher, and often uncertain tax rate for the rest of the project life. Third, tax holidays tend to encourage bogus arrangements. Some firms take advantage of the tax holiday for 5 years, and then either close down the operation and move elsewhere (in the case of fly-by-night operators), or create new companies even if the new investments are expansions of existing business activities under new names.

86. Fourth, in some home countries e.g., the United States, the benefits of tax holidays to investors are nullified by the imposition of higher tax liability on the global profit of foreign companies at home. In this case, Paraguay is simply transferring tax revenues to the foreign tax authority of a capital exporting country. Fifth, despite its very limited influence in investment decision making of firms, the tax holiday puts a lot of administrative burden on Government officials in charge of screening and approving investment proposals. Investors, on the other hand, need to pay some transaction costs to go through the approval process.

87. All in all, the shortcomings of the tax holiday outweigh the benefits offered by Law 60/90 to the investors and the Government. If the Government wishes to reduce the overall corporate tax burden beyond what is offered by the new tax regime, the tax holiday is not the best way to enhance the attractiveness of Paraguay's tax regime to investors. On the other hand, the sudden elimination of the tax holiday provisions could create a negative repercussion on the general investment climate, since it would weaken investor confidence in the regulatory environment at large, and could negatively affect Paraguay's promotional efforts.

88. The Government should carefully consider better ways to maintain or improve the overall tax structure, and should plan in advance to minimize disruption. In any tax reform, one thing is obvious. The consolidation of the new changes is the first priority. To investors, the stability of the tax regime is much more important than small changes in tax rates, as long as the system as a whole does not impose inhibitively high taxes. At present, three sets of tax variables are important in reviewing the corporate tax structure and investment incentives: the tax holiday, incentives for reinvestment, and other incentives.

89. As for the treatment of the tax holiday, one option is to maintain and stabilize the present tax regime, but to gradually eliminate Law 60/90. Experience shows that negative perceptions arising from the elimination of tax holidays can be reduced for instance by an advance announcement to prospective investors that they could apply for the tax holiday until a predetermined future date, e.g., 1 year from now. Then, the tax holiday regime can be phased out gradually as the holiday privileges would expire one by one as existing projects mature.

90. Another option is to establish a lower, but uniformly applied profit tax rate, at the same time as the Government eliminates the tax holiday. Discussions in Paraguay indicated that some officials are seriously considering the introduction of a much lower corporate profit tax of 10%, combined with a 15% tax on all distributed profits both domestically and abroad. This would reduce the effective tax on new investments from 33.5% to 23.5%, factoring in withholding taxes on dividends, and

would provide an excellent opportunity to eliminate the present tax incentive regime.[37] In this case, the Government could offer existing investors an option either to stay in the existing regime or to switch to the new universal regime. The existing investors would be given a time limit to decide, say within one year. As with the first option, the application for the tax holiday would not be processed after a certain preset date, and the holiday would be phased out gradually.

91. The last issue is whether or not to introduce performance-based incentives in lieu of the existing tax holiday provisions. As discussed in FIAS's previous report, as compared to tax holidays, performance-based incentives offer some advantages. Performance-based incentives do not require a separate administrative structure. They reward investors on the basis of their performance against certain criteria evaluated within the normal tax reporting process. However, given a choice between introducing performance-based incentives and moving toward the proposed simplified tax regime, FIAS would recommend the latter over the former. Analyses indicate that most performance-based incentives would only induce unnecessary distortions and complications. If the Government still feels it is necessary to offer some performance-based incentives, the measures should be carefully designed and applied in a very selective manner.

92. If the Government still wishes, only a few very specific performance-based incentives could be attached to the general tax regime without introducing too many distortions. One example is to allow for more deductions for vocational training expenses that private firms assume inside and outside Paraguay for their operations in the country (see Chapter II-A). If such a scheme is successful, its social benefits will exceed its private benefits. Another example is to allow an extra deduction for the wages when multiple shifts are used. This would partly compensate the firms for higher overtime wages. For the economy, it would mean a higher rate of asset utilization.

93. The last example of a specific performance-based incentive is to give a zero, or very low, corporate tax treatment only to processing industries exporting 100%, or almost 100%, of their products. Experience shows that if a country desires to attract the so-called "foot loose" industries, the country has to offer extremely low taxes on their operations.[38] Of course, general economic policies and other fiscal provisions

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[37] Whether the proposed magnitude of reduction in tax rates is the best is beyond the scope of this report.

[38] The "foot loose" industries include export-oriented processing industries, for example, in garments production, electric and electronic assembling. Globally, they are largely dependent on imported inputs, export to highly competitive markets, and operate with very thin profit margin. Among export-oriented industries, they tend to

affect export performance much more than incentives for export promotion themselves. As in the case of high performing East Asian economies, however, the creation of a tax-free environment for "foot-loose" industries, if they are integral part of an export-push strategy, would increase the attractiveness of Paraguay to that type of investors.

B. Infrastructure

94. For Paraguay to attract export-oriented FDI, the development of transport infrastructure is obviously one of the key elements for success. Within MERCOSUR, trucks, river cargo and railways are the major modes of transport used for commodity trade. For example, of the 1.5 million tons of grain and cotton fiber that Paraguay exported in 1990, roads handled 50%, river transport 36%, and the railway the remaining 14%.

95. Despite its importance, public investment in transport infrastructure has been low. Between 1985 and 1990, it averaged about 0.5% of GNP and 2.6% of gross investment. These figures are very low by international standards. Most countries spend 2-5% of GNP on transport infrastructure. The comparable figures were 1.8% of GNP and 15.0% of gross investment in Uruguay, and 1.5% and 10.0% in Chile.

96. As a result, fewer than 10% of national roads are paved; dirt roads often become unusable following rains. As for river transportation, the last major investments made in the port of Asuncion, the country's major port, date back more than sixty years, and port facilities need serious upgrading. River navigation becomes very difficult, or sometimes impossible, during the dry season mainly due to the buildup of silt. Lastly, railroad facilities have been left to deteriorate since 1910 when the last significant investments were made. The trains now operate on a very limited capacity, normally twice a week. The wood-burning locomotives run at an average speed of 20 km/h.

97. The additional costs of transport that investors have to bear when they locate their operations to Paraguay are substantial. The costs of transport between Asuncion and Buenos Aires and those between Asuncion and Montevideo can be summarized in Table IV and Table V below.

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keep overhead expenses low and relocate relatively easily to different investment sites.

Table IV - Costs of Transport ASUNCION - BUENOS AIRES

Mode of Transport	Grains (US$/Ton)	Oils (US$/Ton)	Lumber (US$/Ton)	Cotton (US$/Ton)
Land	29.8	29.8	29.8	29.8
River	18.0	24.0	24.0	25.0
Railroad	46.0	53.0	46.0	58.8

Source: PROPARAGUAY Investors Guide, March 1993.

Table V - Costs of Transport ASUNCION - MONTEVIDEO

Mode of Transport	Grains (US$/Ton)	Oils (US$/Ton)	Lumber (US$/Ton)	Cotton (US$/Ton)
Land	33.5	33.5	33.5	33.5
River	18.0	24.0	24.0	25.0
Railroad	69.1	59.6	55.2	60.4

Source: PROPARAGUAY Investor Guide, March 1993.

98. There are three Brazilian seaports accessible from Paraguay through different routes; Paranagua, Rio Grande do Sul, and Santos. Paranagua is the principal destination of Paraguayan exports. Land transport by truck is the only means of transport. Shipment by truck through the Asuncion-Ciudad del Este-Paranagua route costs approximately US$26.8 per ton. An alternative export route is Encarnacion-Rio Grande do Sul. Cargo could be shipped by land or railroad. Shipment rates via land are about half of those of railroad - US$26.7 per ton by land and US$48.0 per ton by railroad. A less desirable and costly alternative is Ciudad del Este-Panorama-Santos which entails shipping goods by river to Panorama and from Panorama to Santos by railroad. The cost is about US$48.0 per ton.

99. Some regulations seem to be making the situation worse. A bilateral agreement with Brazil defines the number of trucks that may cross from Paraguay into Brazil and the time periods when they may travel. At times, particularly during the soybean harvest season, this control on the number of trucks has slowed down exports. This contributed to a decline in the share of soybean exports transported through roads from 82% in 1986 to 47% in 1990. Another example of the regulations causing problems in transportation is Law 259. The Law establishes that 50% of the

voyage for all river and maritime cargo transport is reserved for Paraguayan vessels. This protection measure has at times caused delays in shipping.[39]

100. Another area of infrastructure that is of direct importance to export-oriented FDI is the provision of modern industrial sites. Several new and potential investors complained to FIAS about the difficulty of finding suitable investment sites that would offer good business facilities, be close to labor and raw materials, and be convenient for transporting inputs and outputs. This problem may not be felt as acutely as the bottlenecks in transportation, but it may be acting as a constraint on new investment. In one interview with a developer of an existing industrial park, FIAS was informed that present zoning regulations interfere with construction of such parks. This is a matter that merits Government attention.

101. The present Government is beginning to reverse this trend. Some public sector projects, assisted by the World Bank and IDB loans, are starting initially for the modernization of road networks. The expansion of the airport in La Ciudad del Este by the Japanese Government has just been completed. The Ministry of Communications and Public Works already has a master plan for Paraguay's transport infrastructure, developed with assistance from the JICA.

102. Much more is needed, however, to modernize the infrastructure at an adequate rate. One element lacking in the current discussions is the potential benefits of private investment in infrastructure development in Paraguay. Considering the financing constraints of the Paraguayan Government as well as multinational institutions and the large amount of investment required, it would not be easy to speed up infrastructure development without active participation of the private sector.[40] Further, experience shows that the private sector normally performs better in terms of construction costs and times, management and services.[41] In so doing, they introduce competition to the market. Moreover, greenfield projects developed by private firms are normally a politically easier way of involving the private sector in

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[39] Because of the Export Promotion Law, Law 90/90, exporters of non-traditional goods are no longer subject to this restriction.

[40] The transport sector master plan of 1991 estimates that about US$2 billion would be needed to modernize Paraguay's transport infrastructure up to an adequate level. The plan would involve 23 projects, some of them extending to year 2010. The study indicates that about 16% of the projects could be handled by the private sector, for instance through BOT schemes.

[41] Private projects tend to have average time overruns of about 20%, significantly below those of public projects of 50%-90%. For instance, Uruguay's decision to unbundle port facilities and use private firms for port operations led to a significant improvement in the provision of port services.

infrastructure financing and management than outright privatization of existing business infrastructure.

103. Private greenfield projects can be an entry into parts of the market (e.g., new port facilities and independent transmission facilities); but they also can leave SOEs relatively untouched. This so-called "unbundling" could occur in several ways: by type of services (e.g., stevedoring, storage, ship-handling, maintenance dredging); by production stage (e.g. generation, transmission, distribution); by geographic area (e.g., a regional railway franchise); or by market segment (e.g., local, long distance, cellular telecommunications services).

104. Such arrangements using concessions as the Build-Operate-Transfer (BOT) and the Build-Operate-Own (BOO) permit flexibility as to eventual assets transfer to the Government. These arrangements represent an alternative both to privatization and permanent ownership of assets by the private sector.[42]

105. At present, the major problem for private provision of infrastructure in Paraguay seems that the Government has yet to develop a policy on this subject. FIAS met in Asuncion and Sao Paulo a few investors who expressed interest in investing in transportation facilities and industrial sites, albeit on a small scale. Apparently, a few proposals had recently been submitted to public offices. FIAS did not encounter any opposition to the idea among public officials. A private industrial park adjacent to the port of Villeta was built already in the end of the 1970s. Several ports as well as a majority of the Paraguay fleet are privately-owned. A private cellular telephone company was established a few years ago. The first round of privatization is scheduled to turn the existing railway and river fleet into private companies.

106. Nonetheless, potential investors do not seem to receive public encouragement for greenfield projects. At present, it seems difficult for investors to ascertain procedures necessary to start private infrastructure projects. For instance, in one case, a potential investor was told that some special taxes would be charged in addition to normal corporate taxes; but the legal basis for such a surcharge was not clear. FIAS did not conduct a thorough analysis of the legal framework affecting such

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[42] Under the BOT and BOO approaches, one or more sponsors from the private sector create a project company to build a facility. The project company also raises the bulk of the financing required for the project from various lenders. The project company often assumes most of the financial risk of the project. The company owns and operates the facility for a period of time which is intended to be sufficient to retire the debt and provide reasonable return to the equity investors. At the end of such a time period, each contract determines the methods of asset transfer or contract review.

greenfield projects. It seems, however, a lot of work needs to be done to develop a good policy framework.

107. A wealth of experience has been accumulated recently concerning private sector infrastructure development in developing countries. Although the overall investment environment affects private sector infrastructure projects like any other private investment, private infrastructure projects have special characteristics that require careful treatment. Those projects have long lives, are large and often complex technically and financially, have immobile products, have numerous public policy implications, normally generate only local currency revenues but debt and equity payments are often in hard currencies, have often been dominated by public monopolies, are highly vulnerable to regulatory changes, and charge tariffs that often have a high political profile.

108. Because of their characteristics, the Government should develop a regulatory framework that would make it feasible to: (i) reduce restrictions on entry and (ii) unbundle monopoly businesses and promote competition. Experience shows for instance that rigid controls on service charges block the entry of new investors. Difficulties in obtaining official authorizations, franchises, and licenses also create serious barriers. For example in Paraguay, Law 489/74, Decree 40,454/83, and Decree 1663/88 seem to establish a rather rigid fee structure for port and customs services. In addition, even if unbundling is legally permitted, new private firms often encounter considerable difficulty in establishing market shares, when the incumbent former monopoly controls upstream and/or downstream activities. The absence of effective competition rules and an independent institution to enforce them is also an impediment to new investments.

109. While developing a proper regulatory framework for private infrastructure development, the Government may enter into concession schemes such as BOT. As long as the legal system is reasonably developed, those schemes compensate for some of the weaknesses in the overall regulatory framework by defining detailed terms of agreement on a case by case basis. The schemes tend to be successful when contractual arrangements between the private investor group and the Government are such that both risks and benefits are appropriately shared.

110. The Government could assume project risks that are beyond private investors' control. For instance, to counterbalance the foreign exchange risk arising from the revenue-payment pattern, the Government could permit: (i) the project company to levy charges in a hard currency; (ii) the project company to levy charges in the local currency but to specify the exchange rate for converting tariff charges into a hard currency under a purchase agreement; or (iii) a tariff structure or other arrangements to give return on an asset base that explicitly includes the cost of foreign debt services. When there is a perceived risk that public agencies may not meet their contractual obligations to supply inputs to or buy outputs from the private company,

the Government may provide guarantees for instance by using: (i) an offshore escrow account, where the payments and legal framework are subject to international legal standards and arbitration; (ii) a by-pass arrangement by which the outputs and/or inputs can be sold or purchased directly on the market; and (iii) a revolving letter of credit from public buyers covering some payments in advance. In some cases, the Government also assumes certain market risks. For railways, ports, or toll roads, government agencies awarding concessions sometimes provide a safeguard when the demand for services becomes very low, owing to extremely adverse market conditions such as a massive crop failure. The private firm may be allowed to extend the life of the concession, to delay the original investment program, or waive concession payments to the Government for a certain period of time.

111. Private companies, in turn, normally bear various commercial risks. The project company bears construction risks by: (i) using fixed-price, certain-date turnkey construction contracts; (ii) taking out insurance policies; (iii) building in a contingency to cover for variations. The project company also bears operational risk by undertaking to operate and maintain the infrastructure assets in such a way that they meet pre-agreed performance criteria with bonuses and penalties.

C. Red Tape

112. Paraguay is making progress in eliminating or reducing bureaucratic procedures that increase uncertainty, slow down business entry, and increase transaction costs for business activities, including export.

113. One area that the previous FIAS work focused on was the company incorporation process. The previous analysis showed that the establishment of stock companies (sociedad anonima) was unnecessarily complicated and time consuming. The problems included: (i) the need for Paraguay's President to sign the incorporation documents, (ii) the document review requirements by judges, the Fiscal General, the Ministries of Finance and Interior, (iii) the cash deposit requirement with the Central Bank, (iv) and the immigration law requirement for foreign directors of the new company either to obtain a residency status or Paraguayan citizenship.

114. By the time of FIAS's mission, a bill had been submitted to the Parliament to eliminate (i), (ii), (iii), and to make it possible for a judge to assume all the document review responsibility. FIAS was also told that the President's office is considering changes in the immigration law to create a business visa category.

115. Another bottleneck especially for export-oriented FDI used to be the complicated export procedures, exacerbated by the various export taxes that existed until the tax reform of 1992. According to the Ministry of Industry and Commerce,

until several years ago, more than three hundred bureaucratic transactions were necessary to obtain an approval to export.

116. While implementing the trade reform, the Government has drastically reduced the number of steps that were required for exportation. The Ministry told FIAS that now exporters need to go through only about 14 procedures. Depending on the experience of the particular "despachante," export now takes between one and a few days. In addition, several investors FIAS met were apparently using the Temporary Admission Regime, which in the past was too complicated and used by few companies. With the simplification of the import duty structure, import procedures are also said to have improved, though importing still takes between a few days to a few weeks. The Government is still working on some procedures to reduce confusion mainly arising from the implementation of the new tax and trade rules.

117. FIAS's previous work also discussed the procedures for Law 60/90 tax incentives. Although much of the system remains the same, the Ministry of Industry and Commerce simplified the application format, the equipment list in particular. Instead of detailed equipment lists containing all the specifications and models of equipment to be imported, the applicants are now required to submit only the number and the description of the equipment to be imported, so that they would not have to reapply and go through the application process again whenever they need to change models. The approval process is currently said to take between 3 and 6 weeks.

118. Despite these areas of progress, several investors commented on the continuing bureaucratic problems they face in Paraguay. Businessmen from surrounding countries seemed inured to these difficulties, but investors from North America and Europe were vocal in their complaints. These are matters that are largely within the Government's power to rectify, and immediate steps should be taken to eliminate sources of red tape.

D. Access to Domestic Financing

119. Today, private firms in Paraguay have access only to short-term financing, seldom extending beyond 180 days. There is a serious lack of medium- and long-term financing, a problem which has long constrained the development of Paraguay's private sector. Underlying this phenomenon is a whole range of problems undermining the development of a modern financial industry. For instance, interest rates were administered and negative until 1990, subsidized credits were directed to such preferred borrowers as agricultural producers and SOEs, and the Central Bank's reserve requirements for commercial banks were extremely high, e.g., 42% on savings deposits in 1990. Prudential regulations were very weak. The Central Bank did not have autonomy.

120. In principle, transnational corporations can raise investment funds in their home countries, and transfer them as advances or equity to their operations abroad. Nonetheless, the interviews indicated that a lack of medium- and long-term fiance is a serious impediment to foreign investment in Paraguay. There are three major reasons. First, to hedge against currency risks, some foreign investors, for instance the ones interested in infrastructure development, would like to match Guarani-based revenues with Guarani-based debt payments. Second, most foreign projects in Paraguay are small, and managed by small- or medium-sized firms that have very little, if any, debt capacity in their home countries. Third, few commercial banks in their home countries would be interested in extending loans for greenfield projects in Paraguay, due to its perceived country risk. Or, the interest charges for the loans would be very high, even if the banks were willing to lend.

121. The Government has been implementing a comprehensive reform to modernize the financial sector. The success of this reform will eventually enable banks to lengthen the terms of commercial loans. Starting from the abolition of the multiple exchange regime, the Government has already implemented many positive measures, e.g., liberalization of interest rates and reduction of the deposit requirement. With the support from the IDB, the Government has also begun to strengthen prudential rules as well as the Central Bank. New legislation such as the Central Bank Law, the Law of Banks, a leasing law and a trusts law have been submitted to the Parliament. In May, working with the World Bank, the Government was preparing an industrial development fund that will extend longer-term loans to private businesses on commercial terms.

122. In addition, in Paraguay foreign banks already are important players. Among the 27 banks registered at the beginning of 1993, 13 were foreign-owned. The aggregate asset position of the foreign-owned banks exceeded that of the Paraguayan banks by one-third. Although they should not be treated in a preferential way, the active participation of foreign banks would accelerate the pace of financial sector modernization. Foreign banks can readily transfer new financial products and techniques. They have much more access to funds in foreign currencies than their Paraguayan counterparts.

123. However, their actual contribution seems to have been limited. Foreign banks FIAS interviewed stressed two main problems working against longer-term lending. One obstacle stems from the generally weak financial reporting system in the country. Due to the weak financial reporting system in general, and the wide-spread practice of keeping double and triple financial records in particular, analyzing credit worthiness of companies is extremely difficult.[43] However, external auditing is not

[43] This problem is also one of the key reasons why the stock market is slow to develop in Paraguay.

yet required except for financial institutions. The other obstacle is that due to the high perceived non-commercial risk of the country, their headquarters or home country regulations restrict lending to firms in Paraguay.

124. The Government should develop measures to encourage external auditing for businesses, with a turnover above a certain amount, particularly if they are going to be listed on the stock market. To do so, some type of "amnesty" may be necessary for companies to start reporting their real financial status. The country risk rating cannot be changed overnight. Nonetheless, the use of political risk guarantee schemes, such as the one offered by the MIGA, can be utilized to reduce the lending restrictions in the home countries of the foreign banks. With such external political risk guarantee schemes, foreign banks would normally have more flexibility in extending longer-term loans.

E. Law Enforcement

125. Many observers see the lack of effective law enforcement mechanisms as one of the major weaknesses of the FDI environment in Paraguay. The judicial branch lacks autonomy, and is susceptible to political influence. Training for the legal profession, especially judges, is weak. As manifested by smuggling, a large part of Paraguay's economy has operated underground to avoid the regulatory and tax related costs of operating in the formal sector. The existence of a large informal economy has negatively affected the formal law enforcement system.

126. An assessment of Paraguay's legal environment has been underway, and the Government has begun to address problems of law enforcement. For example, at the time of FIAS's field work, a bill was submitted to the Parliament to grant more independence to the Supreme Court. The Government is beginning to update the land registration system, a project which will hopefully reduce the incidence of land disputes.

127. Nonetheless, it will take some time to modernize the whole judicial system and train a sufficient number of legal professionals. In the short run, though they would not be a substitute for the formal court system, the Government may consider the use of less formal, and normally less complicated conflict resolution mechanisms such as arbitration. According to a study done by the IDB, in Paraguay domestic commercial arbitration has not been used as an alternative to the formal judicial system. The laws allow for local arbitration; but arbitration centers have not been established.[44]

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[44] Regulatory Framework for Foreign Investments in Paraguay, Inter-American Investment Corporation, Washington D.C. July 1992.

128. As for international arbitration, Paraguay has become a signatory to the Inter-American Convention on Commercial Arbitration, the Inter-American Convention on Recognition and Implementation of Decisions of Foreign Courts, and the International Center for Settlement of Investment Disputes (ICSID). Legally, now, private companies should be able to use international arbitration, because of Law 117/91 which establishes the possibility of submitting disputes either to local or to international arbitration. The IDB study indicates, however, that there is some confusion or at least a lack of experience as to international arbitration, because the Civil Code has long prohibited submission of commercial cases to foreign jurisdiction.

129. To enhance investors' confidence in Paraguay's investment climate, the Government should continue to strengthen the formal legal system. Simultaneously, it should study the ways to make use of domestic and international arbitration as a complementary forum for commercial dispute.

F. Investment Promotion

130. Some overseas promotion as well as investor services have been undertaken, either through ProParaguay, through diplomatic offices, or through Ministries. FIAS encountered a few investors in Buenos Aires who had recently been given information about Paraguay in general and the tax incentive law in particular. Meetings and conferences seem to have been used to make initial contacts with potential investors abroad. Most investors who had already visited the country indicated that the general attitude of the Government had become much more favorable toward private investors than several years ago, and that many officials are helpful in facilitating investment.

131. FIAS did not review this topic in detail. Nonetheless, a few general subjects arising out of this study may be relevant to Paraguay's promotion efforts.

132. The first option the Government could take is to place more weight on export-oriented investment promotion, rather than export promotion of what Paraguay already produces. As the previous FIAS report argued, export promotion and investment promotion are very different activities. The countries that are targets for direct investment in Paraguay are not necessarily the same as those that are targets for purchase of Paraguayan goods. Even within a specific company, the business executives responsible for import decisions is almost always different from the one responsible for decisions regarding new investments. Also, the ways in which purchasing (importing) decisions are made are very different from those for

investment decisions. Thus, export and investment promotion each require different staff skills, market information and promotional materials.[45]

133. There are two factors that favor focusing on investment promotion rather than on export promotion at this point. One is resource constraints on promotion activities. ProParaguay seems to have a reasonable amount of budget at least for providing investor services.[46] A more serious bottleneck seems to be a lack of people with appropriate skills. ProParaguay as well as the Ministry of Industry and Commerce does not have enough qualified people to meet the needs of an increasing number of private investors. As a consequence, efforts seem to be spread thin, trying to do both export promotion and investment promotion. The other factor is that generally speaking Paraguay still does not produce many commodities that are competitive abroad, apart from some traditionally exported primary commodities. To develop new products that will be marketable abroad, Paraguay first needs more export-oriented foreign investments.

134. Sectoral targeting is another issue that needs to be discussed further among policy-makers. It may not be a good idea at this point to try to select small subsectors, since comparative advantage is dynamic and Paraguay is still searching for its strengths within the evolving regional market. What may be useful is for the Government to target the secondary sector in general and processing industries in particular. As shown in Chapter I-A, that is where FDI is growing the fastest and most new investment ideas are discussed.

135. As for the geographical targets, promotional efforts would be most cost effective if they center on the MERCOSUR countries. Brazilian and Argentine investors are the top priority because of geographic proximity, cultural similarities, the ease of communication in Spanish and Portuguese languages. Moreover, foreign investors of other national origin can be contacted at least initially through their regional headquarters within MERCOSUR. Promotion offices abroad would be

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[45] As FIAS recommended as a second best solution short of establishing two separate agencies, ProParaguay now has two separate departments, one for export promotion, the other for investment promotion. However, it was not clear how business plans and budget are separated and coordinated between the two departments.

[46] ProParaguay currently has an annual budget of about US$1 million. Almost all its budget comes from the Ministry of Industry and Commerce. The United Nations Development Program contributes less than 10% of the budget, but administers this project for ProParaguay through its field office in Asuncion. Officially, the Ministry of External Affairs is a co-sponsor of ProParaguay. Up to now, however, this Ministry has not made financial contributions.

neither cost-effective nor necessary. In addition to major cities in the region, medium-sized cities particularly the ones closer to the Paraguayan boarders may be approached. Anecdotal evidence suggests that there are quite a few Brazilian firms from the border regions expressing interest in Paraguay.

136. Lastly, the Government should take advantage of new developments. If for instance the new energy-intensive projects are successful, they will have a very cost effective promotion effect. Investors listen to investors. Success stories are the best proof that Paraguay's investment climate has really changed. The Government should do its best to make sure those projects do not encounter serious difficulties as a result of unnecessary regulatory bottlenecks. Similarly, the success of the first round of privatizations is vital for image building. As stated before, the investment community is paying much more attention to how the privatization is taking place than before. Not only would speedy and transparent implementation of the first round of privatization affect the subsequent, more important round of privatization, it would enhance the image of Paraguay in the investor community at large.