

Starting up a Hotel in Cusco

Written by

Sara Arobes

Director of the Public Sector Area
Málaga Webb & Asociados S.R.L.
(Peru)

This case was developed using information available in the public domain and those provided by PROINVERSION, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

© 2008 APEC Secretariat

Executive Summary

One of the most important economic sectors in Peru was tourism. Peru had many natural, historical, archaeological resources which presented a lot of potentials for the development of tourism infrastructure, services and related industries. These business potentials constituted an opportunity for both national and foreign investors who were accorded equal treatment under existing Peruvian investment regulations. Likewise both types of investors had to face the same problems in starting a business such as land registration and the acquisition of construction permits and other forms of authorization.

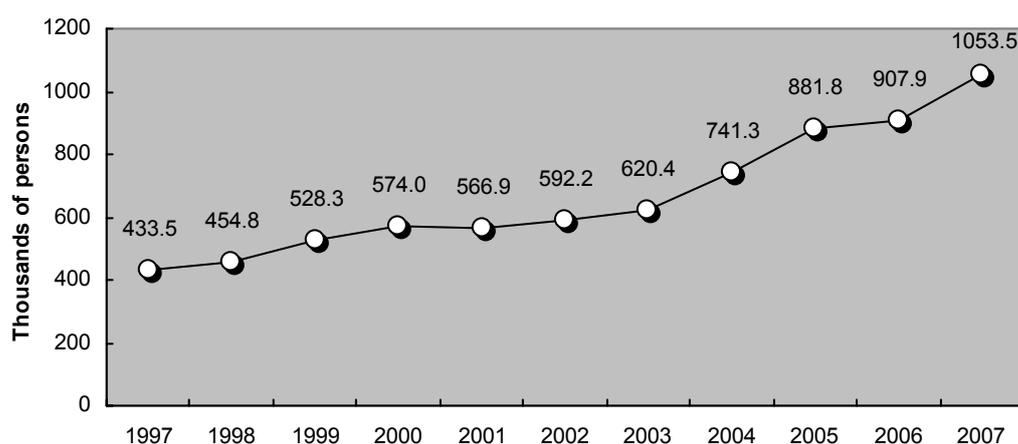
This case study examines three interrelated approval procedures for establishing a hotel in Cusco, Peru. These procedures which included the issuance of the construction permit, preparation of the Project evaluation and the conduct of the archaeological study were the responsibility of both a national body (the National Institute of Culture or "INC") and the local government authorities.

The case highlights the lack of clear guidelines on where to start the process of obtaining these project requirements as well as the absence of an administrative mechanism that could facilitate collaboration between the INC and the local government. Under these conditions, the total time spent by a potential investor in order to obtain the required authorizations was approximately 200 days.

Introduction

One of the more relevant economic sectors in Peru was tourism. According to official data, international visitors to Peru had more than doubled over the last five years, as shown in the following Figure 1.

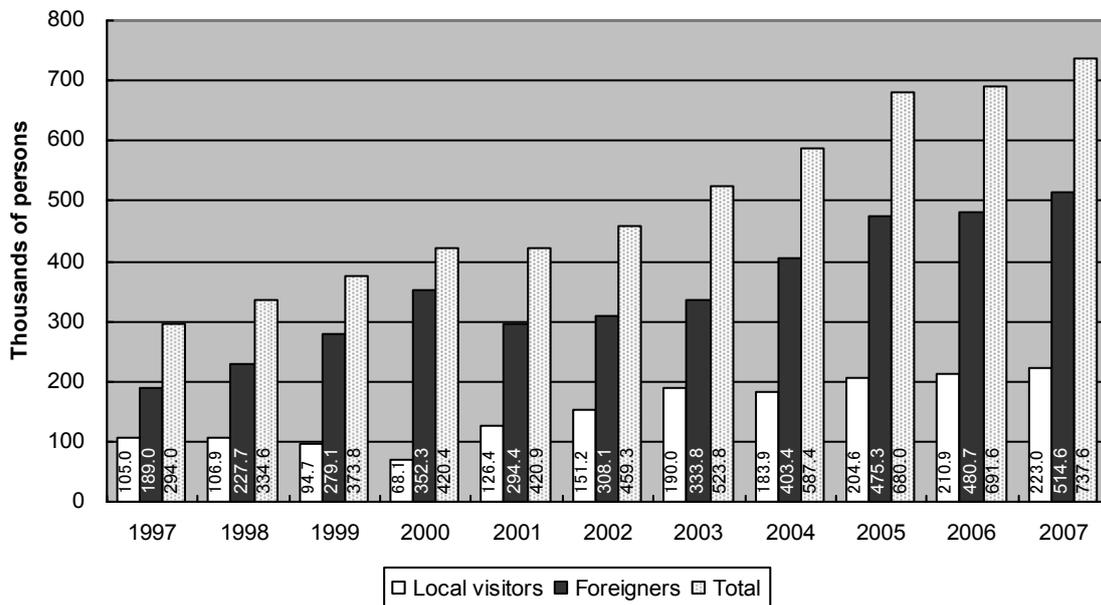
Figure 1 Foreign Arrivals at J. Chávez International Airport: 1997-2007



Source: MINCETUR

One of the most important destinations in Peru was Cusco, the cradle of the Inca civilization. Located in the southeast, Cusco was a World Heritage Site and had one of the Seven Wonders of the World, Machu Picchu, which received more than 700,000 visitors in 2007 alone. (See Figure 2 below.)

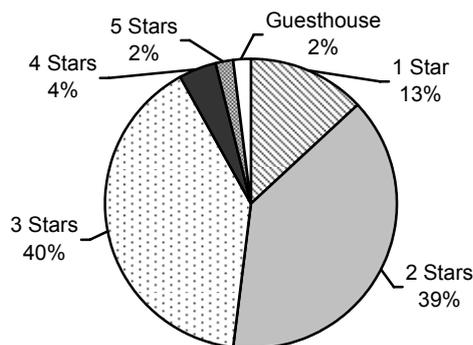
Figure 2 Number of Visitors to S.N. Machu Picchu: 1997-2007



Source: MINCETUR

Cusco accommodations offered visitors a wide range of value choices. As shown in Figure 3, majority or 40% of the hotels in Cusco were 3-star hotels, closely followed by 2-star establishments which accounted for 39%. At the high end of the price and quality range were 5-star hotels which made up 2%. At the lowest end of this range were guesthouses which represented an equal share of 2%. Hence, there were as many 5-star hotels as there were guesthouses.

Figure 3 Percent Distribution of Cusco Hotels by Category: 2007



Source: MINCETUR

If the recent trends showing an increase in the number of visitors (both foreign and local) to Cusco were to continue, the city would need to invest more in infrastructure and to improve the range of services offered to the visitors. Thus the efficiency and effectiveness of the planning and approval process for tourism-related investment would be very important. There would be a need to balance the response to the increasing demand for tourist facilities with the preservation of the region’s unique heritage. Specifically, the challenge would be to reconcile the need for effective investment promotion and the facilitation of new business opportunities with the need to protect the heritage of the territories in which the historical monuments were located.

Given this context, this case focuses on the approval procedures required to establish a new hotel in downtown Cusco or more specifically the procedures related to the issuance of construction permits. The key question is whether the clearances required are sufficiently rigorous or unduly complex. To address this question, the case zeroes in on the most important approval procedures that are lodged with the following public entities: the National Culture Institute and the Provincial Government of Cusco. Information and data on the procedures were provided in part by the Investment Promotion National Agency (PROINVERSION).

Summary of Peru's Tourism Law and Regulations

According to Peruvian government sources, there were at least three institutions concerned with tourism at the national level: 1) Ministry of Foreign Trade and Tourism, 2) PROMPERU, an agency promoting tourism and exports, and 3) National Culture Institute. However if an investor wanted to build a hotel or lodge in a territory classified as a natural protection zone, he would also have to conform to the regulations of the National Institute of Natural Resources (INRENA). For example, in Aguas Calientes, a small town at the last train stop to Machu Picchu in Cusco, the hotels would have to obtain the permission of this institution as well.

The principal legislation governing the provision of tourism services was the Developed Tourism Activities Law (Law No. 26961). Together with its accompanying regulations, the law established the kinds and standards of services that could be provided to the tourists, including accommodation, restaurants, transportation, travel agencies, guides and others. However this law did not specify the procedures relating to the establishment of a hotel. At the local level, the municipalities (in the District or Province) were responsible for granting permission to build a hotel and operate the business.

Foreign Investment Legal and Institutional Framework

The Peruvian Constitutional provisions, the Law for the Promotion of the Foreign Investment (Legislative Decree No. 662), the Law for Private Investment Growth (Legislative Decree No. 757), the Law for Promotion of Private Investment in Infrastructure and Public Service Works (Supreme Decree No. 059-96-PCM), provided for non-discriminatory treatment of both foreign and domestic investments.

Foreign investment was almost unrestricted in most economic sectors. There were usually no preliminary authorization mechanisms and no performance conditions required. Peru guaranteed free transfer of capital, free competition, freedom to own private property, freedom to purchase stocks from locals, access to internal and external credit, payment of royalties, etc. Peru was also an adherent of the OECD "Declaration of International Investment and Multinational Enterprises."

At the national level, the Private Investment Promotion Agency (PROINVERSION) was responsible for promoting domestic and foreign investment together with the Ministries. At the sub-national level, Regional and Local Governments could promote investment or other kind of initiatives in their infrastructure, land, or other properties and assets. However there

could be potential problems in terms of what the National Government, the Regional or the Local Government would consider as priority sectors.

For example, at the beginning of 2008, the National Government approved Law No. 29164 to promote private investments that would improve facilities and services near archeological monuments through concessions. The content of the law raised many issues from the Regional and Local governments because there was a misunderstanding about the objectives of these measures. In Cusco, there was a 24-hour strike demanding that the government revoke the said law. This situation prompted the government to change some provisions of this law.

According to national policies, tourism was one of the most important potential investment sectors fostered by the government through the national bodies. In 2005, the government approved the National Tourism Strategic Plan (PENTUR)¹ (2008-2018). This document set up four objectives to promote sustainable tourism in order to bring about economic and social development in Peru.² It likewise contained an analysis of the main strengths, weaknesses, threats and opportunities of tourism development in Peru. The plan recognized the excessive bureaucracy, the lack of information for investors and the social claims (i.e. public protests, strikes) as threats facing Peru's tourism sector (which are the focus of this case study).

Overview of Peruvian Procedures to Start a Business

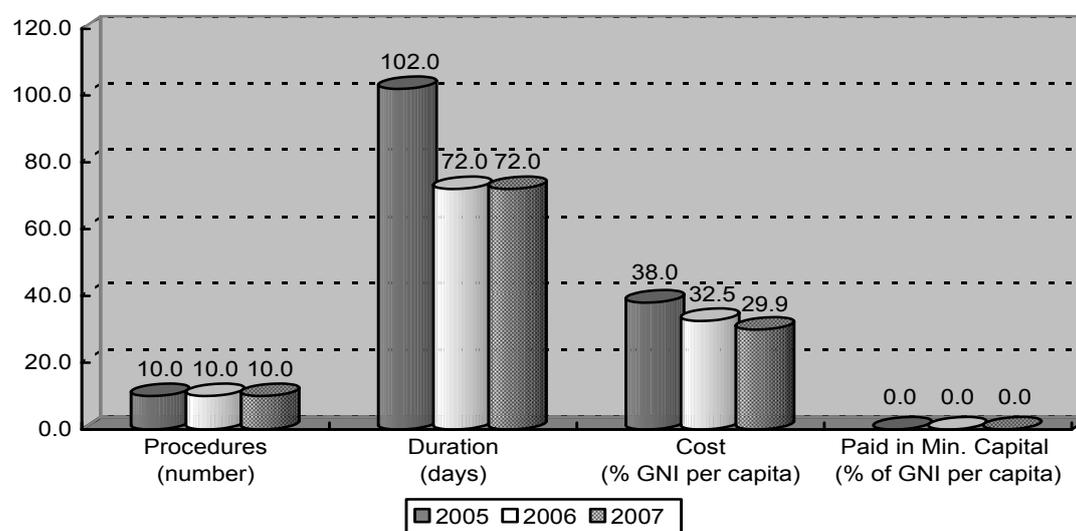
According to Peruvian law and regulations, one could identify a minimum of ten procedures that a person or company must follow to start up a business or company. The complexities of the procedures were related to the nature of the proposed business, which means that depending on the purposes of the enterprise, in addition to the general business registration requirements, other public institutions might be involved in granting permission to develop the specific economic activity. For example, if a company were interested in developing a mining project, the company had to obtain permission from the Ministry of Mining and a further authorization from the Regulation Agency of Energy, Hydrocarbs and Mining.

To give a more complete picture of what a potential investor must do to obtain the necessary clearances, it must be pointed out that there were three distinct groups of procedures that must be followed. The first group consisted of those procedures that must be undertaken to establish a new business, regardless of its type. These included business registration, taxpayer registration, and authorizations to hire staff. The second group of procedures was related specifically to the core activities of the business and was the responsibility of the national government through the appropriate ministry or public body.³ In the case of tourism, the classification of the standard accommodation (be it a hostel or a five star hotel) was provided by the Ministry of Foreign Trade and Tourism. Finally, there was a third group of administrative procedures that fell under the responsibility of the local governments. These included the issuance of the construction permit and the operating license.

The World Bank published annual benchmarking studies that measured the ease of doing business. (APEC had agreed to link its own work program on improving the efficiency and effectiveness of internal regulations to this research.) According to the most recent *Doing Business* reports (2005, 2006 and 2007), Peru had improved its investment climate by reducing the time required to start up a business from 102 days to 72 days. The main reforms had been focused on the two procedures mentioned above which were the responsibility of the local governments, i.e., the issuance of building permits and operating licenses.

The existence of bottlenecks at the local government level, particularly in the issuance of construction permits and licenses, could in turn be traced to the Municipality Law which vested individual local authorities the autonomy to establish and regulate matters related to urban planning and local economic development within their territories. This means that the potential investor must be prepared to address different requirements and varying fees and time required to process the application, depending on where the company intended to establish its business. As indicated in Figure 4 below, there had been tangible improvements⁴ in recent years in the average time required to start a business in Peru as well as in reducing the cost of doing business. These averages, however, masked differences in the time and cost of starting a business based on the location and the sector of the potential investment.

Figure 4 Peru: Starting a Business



Setting up a Hotel in Cusco

As previously cited, Cusco was the main destination of foreign and national tourists in Peru. The following case study⁵ is based on a hypothetical investment decision to build a small hotel in downtown Cusco, with an area of 480 square meters at a cost of approximately US\$ 115,000 to cover the construction of the building exclusive of the facilities.

Downtown Cusco was a heritage district with many designated monuments. New construction or the renovation of an existing building required the approval of the National Culture Institute (INC), in addition to clearance from the local authorities. However, there appeared to be no clear procedures for securing the required approval, because the two institutions involved in the granting of the clearance for construction had no established protocols governing the procedures. At the practical level, the potential investor had no way of knowing beforehand whether to start with the INC or with the Municipality of Cusco. This added time, cost and complexity to the application process.

The procedure in applying for a construction permit was managed by the municipality, but this in turn was related to two separate procedures overseen by the INC, namely, the “project approval” and the “archaeological study evaluation.”

The Project Approval was an authorization given by INC in order to ensure that the construction project would not destroy or damage an archaeological site or historical place. The INC required an investor to hire an archaeologist to conduct an evaluation, if the construction would involve excavation. This was done to ensure that the work would not destroy any monument of ancient civilization. In order to obtain permission to proceed, the archaeological study evaluation must conclude that there were no archaeological relics or monuments present on the site; otherwise, the approval would not be granted.

As mentioned previously, there were no clear guidelines on where the investor should start the application process. In other words, the investor was left guessing as to what could be the most cost effective and time efficient way of going through the application process for the construction of the hotel. There were three options which a prospective investor could choose from in seeking the necessary approvals. These were as follows:

1. Start with the Construction Permit issued by the municipal authorities.
2. Start with Project Approval (granted by the INC).
3. Start with the Archaeological Evaluation Study for the INC.

In this particular case, the investor chose to begin by approaching the INC to seek Project Approval in order to obtain a positive evaluation of the proposed investment. The investor planned to approach the municipality as soon as the approval documentation had been completed.

The INC required considerable documentation in order to issue the project approval. At least six of the documentary requirements were the same as those required by the municipality for the issuance of a construction permit as follows:

- a. Title to the property
- b. If there is more than one owner, an authorization or permission by the other owners to undertake the construction project.
- c. The following must be presented:
 - Site Diagram showing the location and area
 - *Architectural* diagram (Map of the building)
 - Property registration document
 - Urbanism Parameter Certification (Urban Land Use Certification of the proposed site)
 - Description of the Architectural project

Presenting the same documentation to both the INC and the municipality to secure their respective approval represented additional cost and effort for the investor, as both authorities required original copies of the documents. While official information indicated that it would take no more than 30 days to process the application based on the regime of negative silent disapproval,⁶ unofficial sources estimated that the time required would be at least 45 days. Taking into account the time required to prepare the full documentation, it was estimated that securing the approval would take a total of 109 days.

In order to prepare the full documentation, the investor would have to spend official and unofficial⁷ costs amounting to around US\$ 6,470.00,⁸ which included the fees to process the application, and to hire a professional to prepare and/or acquire the necessary documents such as the property registration copy, other owners' authorizations (if required), etc. However, during the evaluation process of the application, the units of INC could still require the investor to present the Archaeological Study Evaluation.

Archaeological Study Evaluation

Upon filing his application for Project Approval, the investor could be required to submit an Archaeological Study Evaluation by the INC. This evaluation study was intended to protect an archaeological monument or historical site against any kind of damage or threat.

In order to carry out the evaluation, the investor must hire an accredited archaeologist, who would undertake the evaluation under the supervision of an INC staff archaeologist. To begin the process, the investor would have to pay the fee and present the archaeological proposal and copy of the property title. It is to be noted that since the copy of the property title would also have to be submitted as part of the project approval process, this requirement was tantamount to duplicating a requirement by the same institution.

An additional internal approval was required to begin the archaeological evaluation study, namely, the authorization of the INC to start the digging and study by the archaeologist. The subsequent approval stage would be based on the report of the archaeologist. Upon receiving a favorable report, the INC had to issue an administrative resolution authorizing the construction. This document had to be presented to the municipality with all the other required documents to start the construction permit procedure. The time and costs (official and not official) were approximately US\$ 1,038.00 and 49 days,⁹ respectively. This was exclusive of the time spent by the archaeologist in doing the archaeological study.

Construction Permit Procedure¹⁰

The purpose of this procedure was to ensure that a construction project was undertaken in accordance with the relevant national regulations and municipal by-laws. Hence, it required that the construction process should not only meet the stipulated technical requirement (such as occupational health and safety regulations) but also that it should be consistent with local urban planning guidelines. Because the investor in this case intended to build the hotel in a designated heritage area that was subject to the special oversight of the INC, the situation became more complex.

As noted, the investor had to present to the municipal authorities a number of documents which were also required to be submitted by the national agency such as INC. However, there was no provision for covering both requirements in a single submission.

Another barrier was the requirement that the investor should present to the municipality the Urbanism Parameter Certification,¹¹ a document that originated from the municipality itself, whose officials were also the source of the required information. The investor had to initiate a sub-process in order to obtain the information required for this certification. The investor must attach to the application form, diagrams signed by an engineer or architect related to electricity distribution, water/sewage, location, structures, as well as pictures of the neighborhood, soil assessment, and an environmental impact report, among others. Likewise, it was also necessary to obtain a security certification from Defensa Civil (the national entity responsible for ensuring security).

One important component of the evaluation process done by the municipality was the internal approval of the plan by a Technical Commission, a board that included the participation of an INC officer. The Technical Commission was tasked to evaluate all facets of the construction project. Hence, it had to verify whether all local requirements had been met and confirm whether the project would require the authorization of the INC since it

would be located in a national heritage area. At this stage of the process, the Technical Commission could ask the investor to start the procedure for conducting the archaeological study on its own (i.e. not through the municipality). Should the board decide that the project would be very complex, it could require the investor to secure INC approval for the entire project.

Two questions can be asked at this point. First, since the Technical Commission had an INC member, why not give the Commission the mandate to evaluate the project in its entirety instead of requiring the investor to start separate procedures to secure INC approval? Second, at the minimum, why did the municipal authorities not deliver the documents required by both organizations to the INC for the evaluation? In short, it was quite evident that the various approval processes were interconnected and yet there was no apparent effort to create a one-stop facility to facilitate the whole process.

While there are no definite answers to these questions, one may speculate that the lack of a collaboration agreement between the local government and the INC could be one of the factors that contributed to the absence of a clear demarcation of authority and alignment of policies and procedures between the two entities relative to the regulation of construction projects.

The consequences could be seen in the amount of time the investor would have to spend waiting for a response from the municipality. This could take about 60 days with official and unofficial cost of approximately US\$ 1,168.

In summary, taking into account the three procedures, the potential investor would have to spend around US\$ 8,000 and wait more than 200 days to obtain the permission to establish the hotel. This was considerably longer than the general benchmark for establishing a new business in Peru as reported by the World Bank, and arguably a deterrent to potential investors in the Peru tourism sector.

This state of affairs appeared to be the result of the lack of clear guidelines concerning the overlapping requirements of national and local institutions. The time required for the entire approval process was exceptionally long, probably because there was no predetermined procedure for adjudicating applications involving the coordinated effort of both institutions. The official and unofficial costs that the potential investor could incur was a sizeable amount considering the lack of clear information on the specifics of the process, such as hiring an archaeologist to conduct the evaluation study, or preparing the many technical diagrams and documents that the investor would have to present to the INC and the municipality.

Endnotes

¹ PENTUR establishes the guidelines for sustainable and competitive development of tourist activity in Peru. It also identifies the needs for public and private investments in the short, mid and long terms.

² In 2007, tourism generated incomes of more than US\$ 2,222 millions. Source: National Strategic Tourism Plan, 2008.

³ Since 2004 with the decentralization process, functions from the national level have been transferred to the sub-national governments (regional and local) giving them the responsibility to grant permission to some economic activities.

⁴ These improvements can be explained by the approval of the frame law that simplified the Municipal License procedures for start-ups.

⁵ The study was elaborated in 2006 by PROINVERSION. Since then, some regulations have changed and there had been new authorities in Cusco and in the INC.

⁶ In Peru the legislation on the administrative procedures established that an application to obtain a permit could be approved in three ways: automatic approval, positive silent approval or negative silent disapproval. The last approach means that if the applicant did not receive an answer from the decision-making institution within the proscribed time, the application was considered to have been disapproved.

⁷ The official costs were those established in the legal chart of procedures of the public entities, called TUPA.

⁸ Data provided by PROINVERSION.

⁹ Information provided by PROINVERSION.

¹⁰ This procedure was one of the most complex and created bottlenecks for doing business. In 2007, a new law was approved by the Peruvian Congress that simplified and reduced some requirements. However in areas declared as National Heritage sites or with archaeological monuments, the INC had the authority to allow or disallow the construction or rebuild of any building.

¹¹ With the new legislation, municipalities were forbidden to require this document; nevertheless, in the official information of the Cusco Municipality 2008 (shown on the web page), it was still listed as a requirement.

Bibliography

IFC, *Doing Business* 2007.

Ministry of Foreign Trade and Tourism, *National Tourism Strategic Plan (PENTUR)*, 2008.

Municipalidad de Cusco, *Texto Unico de Procedimientos Administrativos*, July 2008.

PROINVERSION, "Study to identify administrative barriers for investment in Peru," December 2006.

