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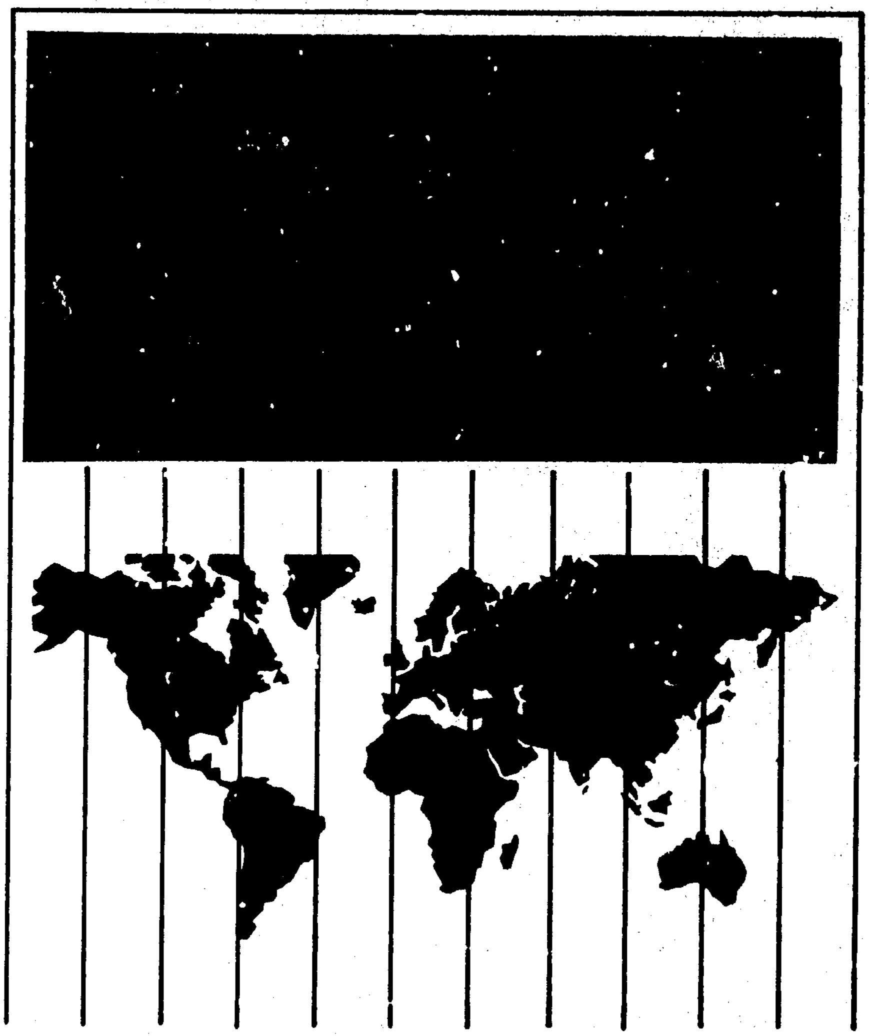

Regional Inspector General for Audit

LATIN AMERICA
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AGRARIAN REFORM IN EL SALVADOR
A REPORT ON ITS STATUS
AUDIT REPORT NO. 1-519-84-2
JANUARY 18, 1984

Under extremely difficult conditions, the Government of El Salvador initiated a large-scale Agrarian Reform Program. Much has been accomplished. The program has redistributed over 200,000 hectares of land to cooperatives and individuals. Yet, the three phases of the Agrarian Reform, which have received about $200 million in AID assistance, have had mixed results. Most Phase I cooperatives are not financially viable. Their future seems bleak without additional assistance. Implementation of Phase II has not been initiated. Phase III has had some limited success but it has many significant problem areas with less than one-half of the eligible recipients applying to purchase the property to which they are entitled.

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GLOSSARY

AID	Agency for International Development
BCR	Banco Central de Reserva (Central Reserve Bank)
BFA	Banco de Fomento Agropecuario (Agricultural Development Bank)
CPA	Certified Public Accountant
DIECRA	Desarrollo Integral de Empresas de la Reforma Agraria (Integrated Development of Agrarian Reform Enterprises)
FAA	Foreign Assistance Act of 1961 as Amended
FEDECREDITO	Federacion de Cajas de Credito (Credit Union Federation)
FEDECACES	Federacion de Asociaciones Cooperativas de Ahorro y Credito de El Salvador (Savings and Loans Cooperative Associations Federation of El Salvador)
FESACORA	Federacion Salvadorena de Cooperativas de la Reforma Agraria (National Federation of Agrarian Reform Cooperatives)
FINATA	Financiera Nacional de Tierras Agricolas (National Finance Office for Phase III Agrarian Reform Lands)
GOES	Government of El Salvador
ISTA	Instituto Salvadoreno de Transformacion Agraria (Salvadoran Institute for Agrarian Transformation)
MAG	Ministerio de Agricultura y Ganaderia (Ministry of Agriculture and Livestock)
OAS	Organization of American States

EXECUTIVE SUMMARY

The El Salvadoran agrarian reform program was initiated in March 1980. The originating decrees provided reform plans which called for expropriating and redistributing all landholdings of 100 hectares or more. The reform program consists of three phases. Phase I concerns land holdings of over 500 hectares. Phase II concerns landholdings of 100 to 500 hectares. Phase III concerns land worked by renters or sharecroppers (Land to the Tiller). Only Phases I and III have been implemented so far.

We reviewed the agrarian reform program to determine its status and to verify uses of selected AID funding. Our field work was conducted during May-October, 1983.

We found that large amounts of land have been made available to peasants and numerous cooperatives have been established for increased agricultural production under the agrarian reform program. These changes have taken place during a time of civil disorders, without a full public consensus about all aspects of land reform and with limited institutional capability to implement the program. Considerable progress has been made under these difficult conditions. Over 200,000 hectares of land has been redistributed to an estimated 500,000 peasants (including family members). Continued progress under this program is, however, heavily dependent upon further financial and other support by the Government of El Salvador.

It should be noted that during the course of this review we found a broad consensus of opinion amongst both U.S. and El Salvadoran participants, planners and observers of the agrarian reform program that the existence of the program represents a remarkable break with the historical tradition of landholdings and use in El Salvador. Further, the consensus seemed to view the break with the past to be essentially irreversible.

AID's funds have been used directly, and indirectly through supporting project activities, to achieve project objectives. In some cases, however, the funds have been used for purposes that were contrary to agreements between the two countries.

Phases of the Agrarian Reform Program

Phase I, by the fall of 1983, had reached a number of the program's goals. Yet it is clear that substantial additional effort and support is vital if the gains to date are to be preserved and progress toward the goals of this phase of the program is to be maintained. Under the difficult conditions existing in El Salvador throughout the three-and-one-half year history of this phase the responsible agency, the Institute for Agraian Transformation (ISTA), is still striving to accomplish a number of key program elements. (See page 8.)

Phase II has not been initiated by the El Salvadoran government (see page 24.)

Phase III had reached approximately the half way point in its stated goal of providing land to the tiller. About one-half of the eligible recipients of land under this phase had applied by April 1983 for the property they are entitled to under this program. Our statistical sample indicated that somewhat less than half of those who had applied were actually working the property at the time of our survey. The El Salvadoran Agency (FINATA) responsible for implementing this phase is enthusiastic about the program and has made concerted efforts to fulfill its functions. Yet, the security situation, resistance by numerous landlords, and ambivalence within the military have limited program accomplishments. (See page 25.)

The future success of the agrarian reform program largely depends upon action to (1) make Phase I cooperatives financially viable operations; (2) effectively implement Phase II reforms, and (3) facilitate the application, registry, transfer of ownership, and use of Phase III farm lands.

Agricultural Development Bank

The El Salvadoran Agricultural Development Bank (BFA) plays a vital role in the reform program by providing agricultural credit. BFA's financial condition has been precarious due to the inability of many of its clients (primarily Phase I cooperatives) to repay loans obtained from the Bank. The added responsibilities of about 100 Phase I cooperatives and the Phase III recipients assigned to BFA under the agrarian reform program have overtaxed BFA's resources, weakened its capital structure and have led to a breakdown in its internal controls system. (See page 28.)

BFA has used the equivalent of about $1.4 million of AID funds for unallowable activities. AID must recover that amount. (See page 32.)

Mission Comments

The Director, USAID Mission to El Salvador, responded to a draft of this report on December 7, 1983.

The Director said that the report failed to adequately recognize the accomplishments of the agrarian reform program in the real world context in which it has taken place. He said the report treated Phase I ongoing processes as no accomplishments at all.

The Director agreed that the financial viability of the Phase I cooperatives was the major obstacle to the success of the reform program. He said that management and restructuring of the debt were needed to establish financial viability of the cooperatives. He said the debt load of the cooperatives must be restructured before they can reasonably be expected to be financially successful. He said the key to restructuring the debt was legislation which would separate the equating of the cooperatives' agrarian reform debt with the compensation paid to former landowners. The Director did not consider the cooperatives poor land quality and excessive memberships as major reasons for the financial problems. The Director also criticized the mehtodology we used in projecting the results of our examination of selected Phase I cooperatives and Phase III beneficiaries.

With respect to the BFA, the Director agreed that at the outset of the agrarian reform program, the Bank was neither administratively nor financially prepared for the task. He said, however, that improvements have been made and that the BFA was stronger today than it was prior to inception of the program. The Director did not offer any comments about compliance with the restrictions placed on AID funds.

The Director's comments were considered in preparing the final report.

I. INTRODUCTION

In October 1979 civil violence culminated in a coup d'etat under which a group of military officers seized control and established a five-member civilian/military Junta. That Junta issued an Armed Forces Proclamation which set forth the purpose of the coup d'etat and the objectives of the new government. The proclamation condemned the abuses of past regimes and announced a National Emergency Program for accomplishing major changes in political, economic and social structures. Among other things, the Proclamation called for a major agrarian reform program.

In early 1980, the Government of El Salvador (GOES) requested AID assistance on such a program. The GOES advised AID that plans were incomplete but the program would be guided by the following principles:

- The structure of land ownership would be fundamentally altered in favor of the campesino (rural peasants) sector.

- The program would be national in scope and would cover all crops.

- No exceptions would be made for lands devoted to special crops, including coffee.

- The program would be carried out with and for the campesinos with the government actively supporting the development of rural organizations, cooperatives, unions, communal associations, and whatever other forms of institutions the campesinos decided upon.

- The program would not attempt to provide a small parcel for each campesino and the concern for productivity would necessitate some criteria for minimum units of production. The GOES in April 1980, modified this principle to allow for Phase III of the program.

Background to the Agrarian Reform Program

Land tenure is an important social, political, and economic issue in El Salvador. In an attempt to deal with the land tenure issue, the Government of El Salvador in 1932 established an agrarian reform agency in the aftermath of a large scale revolt which resulted in the death of about 10,000 campesinos. From 1932 to 1975, government agencies reportedly acquired 67,711 hectares 1/ of land. About 80 percent of that land reportedly was adjudicated to 10,700 families over a period of 43 years. Between 1932 and 1975, the agrarian reform agency went through several changes of name, organizational structure, and operational methods. The present organization, created on June 6, 1975, is called the Salvadoran Institute of Agrarian Transformation (ISTA). ISTA's general objectives are to raise the social and economic level of the small farmer by providing land, technical assistance, credit and other benefits as well as to increase agricultural production and productivity.

1/ One hectare = 2.47 acres.

Government Decrees Nos. 153 and 154 dated March 5, 1980 are the legal bases of the new agrarian reform program. These Decrees established the parameters of the reform, the initial plans for implementing Phase I, and assigned responsibility for implementing the program to the Ministry of Agriculture and Livestock (MAG) and ISTA.

On April 28, 1980, the GOES issued Decree No. 207 which is the legal basis for Phase III. The Decree also contains the initial plans for implementing Phase III.

ISTA did not have the resources to implement both Phase I and Phase III. To resolve this problem, the GOES issued Decree No. 525 on December 11 1980. That Decree created a new organization called the National Finance Office for Agrarian Reform Lands (FINATA). FINATA was charged with implementing Phase III (Land to the Tiller). FINATA's objectives for Phase III were the same as those assigned to ISTA.

Phase I

The GOES began implementing Phase I (expropriation and distribution of landholdings in excess of 500 hectares) on March 6, 1980. On that day, ISTA, in coordination with various elements of the El Salvadoran government began presenting legal expropriation documents to owners of properties containing more than 500 hectares of land. As of March 31, 1983, ISTA had acquired approximately 426 1/ properties under Phase I authority. These properties were organized into approximately 317 1/ production units called cooperatives. The cooperatives' members and ISTA co-manage the units.

Phase I cooperatives are classified according to who financed their production and investment credits. One classification of cooperatives consists of those who receive production credits from the quasi governmental agricultural development bank (BFA). BFA is the single largest provider of production and investment credits to these cooperatives and AID provided funds go through BFA to 94 Phase I cooperatives. The remaining Phase I cooperatives receive their credits from one or more of the various commercial banks that provide funds for agricultural purposes. Financing from the commercial banks for Phase I cooperatives is referred to as mixed bank financing.

Phase II

Phase II was to have dealt with the expropriation and distribution of landholdings from 100 or 150 hectares (depending on the classification of the land) to 500 hectares. This phase has not been initiated.

Phase III

This phase was initiated on April 28, 1980. At that time, the GOES estimated that about 160,000 persons were eligible to receive land under Phase III

1/ These figures are estimated because neither USAID/El Salvador nor ISTA was certain what the exact totals were on any given date.

authority. Subsequently, they reduced the estimated number to 117,000. The implementation period of Phase III has been extended three times and is due to expire on June 30, 1984. As of March 31, 1983, about 50,000 individuals, or less than half of the 117,000 eligible, had filed applications requesting approval to purchase land. 1/

1/ Prior to issuance of this report, FINATA reported that as of December 25, 1983, they had received 75,967 applications from 60,733 individuals.

II. PURPOSE AND SCOPE

The Office of the Regional Inspector General for Audit/Latin America reviewed the agrarian reform program in El Salvador. The review was made in the United States and in El Salvador during May to October 1983.

We sought to answer these questions:

1) How much funding has AID provided for the program?

2) What was AID's involvement in initiating the program?

3) How well is the program working?

4) Has BFA used AID funds properly?

5) Has AID complied with funding restrictions?

To answer these questions, we reviewed pertinent files and interviewed officials in AID/Washington, USAID/El Salvador, the U.S. Embassy in San Salvador and various GOES organizations. We examined pertinent books and records in BFA's central office in El Salvador and selected branch offices in various parts of the country. We visited beneficiaries under Phase I and Phase III of the program and made such other tests and reviews as we considered necessary under the circumstances.

Our field work was limited by the war to secure areas in El Salvador. The secure areas varied from day to day. Incomplete, inaccurate, and at times non-existent records hampered formation of definitive conclusions.

III. U.S. FINANCIAL SUPPORT TO EL SALVADOR'S AGRARIAN REFORM PROGRAM

Since fiscal year 1980, AID has provided over $200 million in support of the agrarian reform program. As of March 31, 1983, about $29 million of AID funds had been provided to the Agricultural Development Bank (BFA). BFA used these AID funds to provide production and investment credits to Phase I and Phase III recipients. The remaining AID funds were provided to various activities in support of ongoing reform activities.

U.S. Assistance to El Salvador
in Support of the Agrarian Reform Program
($000)

Title	FY 1980	FY 1981	FY 1982	FY 1983 Through 3/31/83	FY 1983 Planned Through 9/30/83	Total
Devevelopment Assistance Projects 1/	$14,400	$10,273	$18,625	$ ---	$34,050	$77,348
Economic Support Projects (ESF)	7,577	---	1,600	400	1,600	11,177
Subtotal	$21,977	$10,273	$20,225	$400	$35,650	$88,525
P.L. 480, Title I						
Direct	2,880	8,800	5,500	11,176	N/A	28,356
Indirect 2/	---	5,575	9,000	4,563	N/A	19,138
Economic Support Funds						
Direct	---	20,000	---	---	N/A	20,000
Indirect 3/	---	---	36,200	20,100	N/A	56,300
Subtotal	$2,880	$34,375	$50,700	$35,839	N/A	$123,794
Total	$24,857	$44,648	$70,925	$36,239	$35,650	$212,319

1/ Indirect AID development assistance to the Agrarian Reform sector has been channeled through various ongoing projects. These projects are briefly described on page 6.

2/ GOES-owned funds generated under sales of P.L. 480, Title I commodities, but agreements between AID and the GOES required their use for agrarian reform support.

3/ ESF generations were used in support of GOES 1982 and 1983 Fiscal Monetary Program which included Colones 90.6 million ($36.2 million) in 1982 and Colones 50.2 ($20.1 million) in 1983 for support of the operational needs of the agrarian reform program. (U.S.$1.00 = 2.5 colones).

The Small Producer Development Project (No. 519-0229) is providing $9.750 million (Loan $9 million; Grant $750,000) for technical and training assistance. Also this project is providing capital to FEDECACES and FEDECREDITO (local credit union federations) for relending to individuals and cooperatives. FEDECREDITO is currently servicing 18 Phase I cooperatives and many small farmers participating in this project will be Phase III beneficiaries.

The Public Sector Employment Project (No. 519-0256) is financing irrigation systems, rural water reservoirs, reforestation and soil conservation activities in rural areas which in many cases, include the agrarian reform sector. AID assistance to this project through March 31, 1983 has totaled $40.505 million.

The Small Farm Irrigation Systems Project (No. 519-0184) is providing $2.3 million in tandem with the Public Sector Employment Project to finance the construction of irrigation subprojects in the agrarian reform sector. Twenty-one subprojects have been completed to date. Eight are underway and an additional eight are in the planning stage.

The Rural Small Enterprise and Cooperative Development Project (No. 519-0286) is providing about $1 million in support to strengthen farm cooperatives and enterprises, primarily in the agrarian reform sector, and to develop the newly formed Salvadoran Federation of Cooperatives of the Agrarian Reform (FESACORA).

IV. AID's INVOLVEMENT IN INITIATING THE EL SALVADORAN AGRARIAN REFORM

One of the questions we sought to answer was whether AID was actively involved in initiating the current agrarian reform program. From our review of the record, it is clear that AID had no advance notice of the October 1979 coup d'etat or the new government's intention to initiate major agrarian reforms.

In the Spring of 1976, USAID/El Salvador attempted to develop a project to support the then newly created ISTA in its land acquisition and redistribution program. In late 1976, however, ISTA announced that it planned to expropriate some 56,000 hectares of good land in the Usulutan area. Following that announcement, resistance developed against ISTA's plan and the GOES legislature terminated ISTA's legal expropriation powers. AID at that point stopped actively promoting an agrarian reform program.

With no advance notice of the new government's land reform program, AID nevertheless moved quickly to plan a program to support the effort and signed its initial project agreements to this end in July of 1980.

V. ACCOMPLISHMENTS OF THE THREE PHASES OF THE AGRARIAN REFORM PROGRAM

The agrarian reform program has succeeded in dividing over 200,000 hectares of land among an estimated 500,000 (including family members) of the peasant class, many of whom previously were without land. Over 300 agricultural cooperatives have been created with the objective of establishing viable, self-sufficient, participatory family businesses for many peasants. These changes have taken place in the midst of severe civil strife, less than complete public support for the reform movement, and with the inherent institutional limitations of a developing country.

Notwithstanding these accomplishments, the future of Phase I cooperatives seems bleak without further substantial reforms.

Most Phase I cooperatives are not producing sufficient income to be viable organizations. Income is deficient in part due to the poor quality of lands and excessive membership in the cooperatives. Most Phase I cooperatives have little chance to recover on their own. Phase II has not been started. Phase III appears to be moving ahead but less than half of the eligible recipients have filed applications for property transfers.

Phase I

The GOES pre-implementation planning for Phase I was limited. Both the GOES and AID were in the difficult position of dealing concurrently and on a continuing basis with the development of a rational planning process and with implementation problems resulting from lack of prior planning.

The GOES announced the new agrarian reform program concurrently with the coup d'etat of October 15, 1979. Although the coup apparently was well planned and implemented, it was evident that little preplanning had taken place for implementing the agrarian reform program. The precipitous manner in which the Junta announced its intentions to initiate the program left AID without a policy statement, strategy, or plan of assistance at that time.

The lack of preplanning documentation greatly hindered our evaluation of agrarian reform activities. There was no agreed to baseline data, no specific targeted data, or pre-established required inputs to accomplish program goals. In an attempt to obtain data on preplanning and implementation plans, we interviewed the Minister of Planning, the Minister of Agriculture and the Directors of ISTA and FINATA. These officials said that the Decrees were the only preplanning documents and no detailed plans on the program were available. There were, for example, no pre-established numbers on the amount of land involved overall or in each phase, nor the amount of funding required for compensation.

The GOES' general objectives for the agrarian reform program were contained in Decree No. 153 of March 5, 1980. Decree No. 154 of March 5, 1980, initiated Phase I. Parts of the two Decrees are presented below:

Decree No. 153

"For the purpose of this law, agrarian reform shall be understood to mean the transformation of the country's agrarian structure and the incorporation of the rural population into the economic, social and political development of the nation through the substitution of the latifundia system by a more just system including property or land and the exploitation of landholdings, based on an equitable distribution of land, an adequate credit system, and comprehensive assistance to the producers in order that land become the basis of economic stability for the peasant, as the basis of his greater well-being and guarantee of his freedom and dignity.

"The agrarian reform shall be applied throughout the entire national territory, without regard to crop, location, productivity, land tenure system, quality of soil, or any variable; therefore, all land used for agricultural, livestock or forestry exploitation shall be affected by this law, with the exceptions and limitations established by the law itself.

"Land affected by the present law is understood to be any property within the national territory belonging to one or more individuals, estates, or associations exceeding one hundred hectares for land within classifications I, II, III and IV; and one hundred and fifty hectares for land within classifications V, VI, and VII. These classifications constitute the right to land ownership reserved for landholders."

Decree No. 154

"In order to implement the execution of the first stage of the Agrarian Reform throughout the country, which will include expropriation of landholdings in excess of FIVE HUNDRED HECTARES, either as a whole or a combination of several units belonging to one or more individuals, estates or associations, the Salvadoran Institute for Agrarian Reform is hereby authorized to proceed to immediate intervention and taking of possession of landholdings involved, through delegates of that institution or of the Ministry of Agriculture."

Decree No. 153 makes clear that the GOES' goal was to expropriate and distribute all landholdings used for agricultural purposes exceeding 100 or 150 hectares, depending on land classification. Decree No. 154 authorized the first phase of the reform -- expropriation and distribution of landholdings in excess of 500 hectares.

By March 1980, when the decrees were issued, AID had had insufficient time to develop an overall implementation plan for the reform program.

Concurrent with the GOES issuance of Decree Nos. 153 and 154 on March 5, 1980, the agrarian reform program became the focal point of AID assistance to El Salvador. The status of political, military, and economic reforms has changed so frequently and moved so quickly that AID has been left in the position of trying to keep up with the current state of this large and complex program. Nevertheless, AID has made a concerted effort from the beginning to identify constraints to implementing agrarian reform activities and assisting the GOES by developing specific projects to deal with identified problem areas. As a result, AID has numerous projects and funding sources flowing into institutions associated with the agrarian reform. Each of these AID inputs has a specified purpose, objective and implementation plan.

Moving quickly, USAID/El Salvador, in May 1980, issued a Strategy Paper for assistance to the agrarian reform sector. AID's basic strategy was to analyze the program, identify bottlenecks and constraints to implementation and develop projects to assist the GOES in dealing with the problem areas.

Data on Program Accomplishments are Limited

Attempts to establish the accomplishments under Phase I were hampered by the lack of and the unreliability of available data. Data on all phases of the program were limited and the accuracy of most data suspect. Accordingly, much of the data examined and reviewed in this report were estimates or approximations.

Complete or reliable numbers were unavailable from ISTA on many Phase I reform activities. We could not establish why the information was unavailable but as of September 1983, about 3-1/2 years after initiation of the reform program, ISTA still had not completely:

1) surveyed the properties expropriated.

2) established the amount of land involved.

3) established the class of lands involved.

4) established the amounts owed to the previous owners.

5) established the amounts due from the cooperatives.

6) determined the number of properties expropriated.

In response to our draft report, the AID Mission noted the tasks listed above were ongoing. The Mission provided us with data that they indicated showed progress on the part of the GOES in adjudicating properties and in obtaining knowledge about what was happening on Phase I farms. With respect to item (6) above, the Mission noted that the number of properties expropriated was 194, a figure which "has been a constant ...". This assertion of a "constant" 194 is illustrative of the degree of confusion which we found so pervasively present in the data and baseline information concerning the agrarian reform program. For example:

- USAID/El Salvador in its Project Paper on agrarian reform organization dated September 29, 1980 gave this figure as 236.

- The GOES Ministry of Agriculture reported in July 1982 that the number of properties expropriated under the reform program was 278.

- Checchi and Company, in an AID financed study on the agrarian reform program, reported in January 1983 that the number was 262.

- USAID/El Salvador in its Propect Paper on the Agrarian Reform Sector Support dated May 23, 1983, reported that the number of properties expropriated under Phase I was 360.

- On September 19, 1983, ISTA advised the auditors that the number of properties expropriated under Phase I was 207.

Neither AID nor the related GOES offices had reliable information on other aspects of the program. For example, we were unable to obtain a reliable listing of cooperatives formed by ISTA under Phase I.

After we determined that AID did not have a listing of the cooperatives, we worked with ISTA for three weeks trying to develop a complete listing of Phase I cooperatives as of March 31, 1983. We settled for the listing of 317 cooperatives that ISTA finally prepared for us. We found many errors in the information presented by ISTA. Nevertheless, the listing of 317 cooperatives and related information were the best data on cooperatives available at that time and we used it as the basis for our audit work on Phase I.

Financial information from banks also was questionable. For example, information on loans, expenditures and repayments were frequently reported from a branch bank to its home office by telephone or radio. Documents were not always provided the home office to support the details of the transactions. Also, production data for the period prior to the reform could not be obtained for reformed units except by word of mouth from current cooperative members who stated they had worked on the farm before the reform program.

The civil disturbances have created many unusual problems for the GOES with respect to data collection on field activities. Nevertheless, there is no way to verify accomplishments nor determine necessary actions required to insure the success of the activities without the GOES's accumulating reasonably accurate data on these undertakings. AID's efforts have not been fully successful in offsetting the lack of reliable program management data. Of the 17 cooperatives we visited, we found, for example, that no one from AID had ever visited those farms. USAID Mission files showed that AID officials had visited only one of the 41 cooperatives randomly selected for audit. There are about 317 cooperatives in the program.

The Mission noted in their comments on the draft audit report that as of June 1983, AID staff have visited 4 of the cooperatives included in our audit. The Mission also reported that at the time of the audit, members of its staff had visited 59 of the 317 cooperatives since the initiation of the

Unquestionably, the USAID/El Salvador staff works hard and consistently gives its best efforts. The programs however. are massive, complicated and many are located in very dangerous areas. Further, USAID/El Salvador has a very small staff in comparison to the program in El Salvador. AID's continued support of the agrarian reform program requires establishing some better means of monitoring and analyzing what is happening in the field.

Cooperatives' Financial Viability Is Questionable

From 1932 through June 1979, ISTA and its predecessor agencies reportedly acquired about 82,165 hectares of land of which 61,650 hectares were distributed to 14,563 beneficiaries.

The pre-1980 acquired properties had previously been reported as cooperatives and ISTA referred to them as "traditional cooperatives," that is, a farm owned by the cooperatives' members and operated by them as a private enterprise activity to produce income and goods for their livelihood and profit. ISTA's current records and a visit to one of the units showed that most of the units so classified are not cooperatives. The record showed that:

12 properties had been broken into small plots and assigned to individuals;

48 properties had been transferred to FINATA to be divided into small plots and assigned to individuals;

3 properties had been classified as unusable for agricultural purposes;

32 properties had been organized into 21 production units on which ISTA was attempting to develop working cooperatives;

8 properties had been organized into 4 working cooperatives; and

4 properties were unaccounted for.

ISTA has attempted to implement the new reform cooperatives along the same lines they used for the pre-1980 units. That is, obtain the land, install the campesinos who live on or around the land as cooperative members, and assist them in developing the farms into self-sustaining operations.

We made a random sample of the Phase I and traditional cooperatives to (1) see if they were in operation; (2) verify the use of AID funds, and (3) identify any problem areas affecting their operation, productivity or profitability that had not previously been reported by AID. The sample was drawn from the ISTA listings of 317 Phase I cooperatives and 107 "traditional cooperatives." The sample selected totaled 41 cooperatives which were classed as shown below. Due to security restrictions we were allowed to visit only 17 of the cooperatives selected for audit.

	Selected	Visited
Phase I Cooperatives	35	16
(a) BFA provided financing	(19)	(7)
(b) Mixed-Banks provided financing	(16)	(9)
"Traditional Cooperatives"	6	1
Totals	41	17

Distribution of Cooperatives in the Random Sample

	No. of Phase I Coops	Estimated No. of Hectares	No. of Phase I Coops in Sample	No. of Coops Visited	No. of Hectares in Coops Visited
Western El Salvador					
Occidental	87	63,666	9	7	6,333
Central	78	62,799	9	9	4,008
Eastern El Salvador					
Paracentral	71	37,065	8	0	-
Oriental	81	66,671	9	0	-
	317	230,201	35	16	10,341

The Phase I cooperatives appeared to have been structured without fully considering the basic ingredients necessary for profit making productive enterprises. As a consequence, certain cooperatives have not been financially viable undertakings.

The overall purpose of the agrarian reform program is to increase production, income and employment. Under Phase I, the purpose is to establish viable, self-sufficient, and participatory farm businesses.

Article 19 of Decree No. 153 provides that the allocation of land is to be carried out taking into account a dynamic concept which will include property size and quality of the soil in relation to productivity and income.

As Article 19 recognizes, the basis for any profit-making undertaking is the relationship of capital, labor and management and their costs to market prices. The Phase I cooperatives appear to have been formed without ISTA having properly considered these requisites. Many Phase I cooperatives had (1) massive capital debt, (2) no working capital, (3) large tracts of land that were non-productive, (4) substantially larger labor forces than needed to operate the units, and (5) weak management. This disequilibrium is faced with the weakest market prices experienced by the agroindustry in recent history. These problems alone, without considering the unstable civil and political situation in El Salvador, may prevent most Phase I cooperatives from becoming financially viable enterprises. A financially viable enterprise produces sufficient income to liquidate its current liabilities, pay its long-term debts, satisfy its members' basic needs, and generate revenues for emergencies, replacements, and savings.

BFA and ISTA records on the cooperatives and our visits to 17 cooperatives showed that many Phase I cooperatives:

- borrow production and investment funds at the beginning of the planting seasons. These funds are used in large part to pay themselves for their labor in cultivating their crops, etc.

- harvest and sell their produce for the best price they can obtain.

- receive insufficient income from their sales to repay the funds they borrowed for production and investment purposes.

- have no income to pay their other debts. These debts include annual amortization charges for the property; interest accrued on the debt for the property; production credits received in 1980 (known as the emergency credit), and previous production credits that have been refinanced.

- have no resources for emergencies, new investment, or savings.

The GOES's objectives are for the cooperatives to be able to liquidate their debts, produce a reasonable living for their members and be self-sustaining in the long run.

As the debt has mounted, cooperatives members have become more concerned about their situation. Original expectations of improved economic and social status are perceived by these members to be unachievable without some sort of debt relief and reduction of operating costs.

Available financial data showed that many of the Phase I cooperatives had been unable to repay even the production and investment credits they had borrowed. Four classes of debt currently associated with the Phase I cooperatives are referred to in this report.

1. The Agrarian Debt - This is the capital debt for the value (usually an estimated value) of the land, real estate and other capital assets on the land at the time the property was expropriated. This debt is payable in equal annual installments over a 20-30 year period of time.

2. Interest on the Agrarian Debt - Interest on the agrarian debt is at the rate of 9-1/2 percent annually on the outstanding balance.

3. The 1980 Emergency Credit - During the March-September 1980 period, when the expropriation process was taking place, ISTA provided credits to the newly formed cooperatives on an emergency basis so they could begin operations. These credits were frequently provided in cash. Since 1980, the cooperatives' management and membership have changed substantially and many of the cooperatives' current members do not believe that they received the credits and therefore are not responsible for repaying them.

4. Production and Investment Credits - These are credits provided to the cooperatives under normal business practices by BFA and mixed banks for annual production and investment activities.

The above classes of debt are due in reverse order. Any income received from operations is used first to pay the currently due production and investment credits. Any income remaining after paying those debts would be used to pay on the 1980 emergency credits, (most of which had been refinanced), then the agrarian interest, and then the agrarian debt. Accordingly, when a cooperative does not have funds to pay its current production and investment credits, it also cannot make payments on any of its other debts.

Although BFA and ISTA reported that most cooperatives were repaying their loans, many were merely paying off past debts with new borrowings. These cooperatives were not technically in default on their production and investment credits but their debt was still outstanding.

The San Isidro cooperative is an example of the debt refinancing problem. San Isidro had borrowed a total of $462,000 for production and investment purposes since inception of the program. Of the $462,000, the cooperative had repaid $72,000 of the principal. It is in arrears on a $125,000 repayment due under this credit. However, they had previously refinaced over $50,000 of the $125,000. Of the $265,000 outstanding but not due, $99,000 had been refinanced.

Another example is the Santa Cruz Tazulath cooperative. This cooperative was shown by the banks as being $40,000 in arrears on its production and investment credits. The cooperative's records showed that over $140,000 due on previous production and investment credits had been refinanced. In addition, this cooperative was over $62,000 in arrears on production credits obtained outside the normal financing system.

The financial records of BFA, ISTA and the cooperatives also showed that most cooperatives had not paid the 1980 emergency credits provided for the 1980 planting season. Most of the cooperatives had merely refinanced the credits due. The El Refugio cooperative, for example, owed over $214,000 on its 1980 emergency credits as of June 30, 1983, but this amount was technically not in arrears because it had been refinanced. In August 1983, the Atapasco cooperative showed an emergency credit debt of over $27,000, all of which had been refinanced. The El Tatuano cooperative owed more than $36,000 that had been refinanced.

As of March 31, 1983, most Phase I cooperatives owed all the interest accrued on their agrarian debt since the inception of the program in the Spring of 1980. Only a few cooperatives had made payments on the principal of their agrarian debt.

Of the 17 cooperatives we visited, one cooperative had made a payment of interest to ISTA on their agrarian debt. That payment was less than the interest due. ISTA had completed the required processes and issued titles to 27 of the approximate 317 Phase I cooperatives. Of the 27 Phase I cooperatives that had received titles to their properties, only two had made some payments to ISTA on the principal of their agrarian debt.

The debt of many Phase I cooperatives continues to increase annually. If something is not done to stop this process, the cooperatives will be in such a difficult financial situation that even the government banks may not be able to provide them with production credits. Without the credits, most cooperatives would be unable to operate.

Our field trips to the cooperatives, reviews of their records on site and discussions with cooperative members and officials of BFA and ISTA confirmed that most cooperatives in Phase I were overwhelmed with debt. Few if any will ever be able to repay the accumulated debts from their own resources.

An example of the debt problem is demonstrated by the financial status of the La Labor cooperative. La Labor's financial statements for the year ended March 31, 1983 showed $3.9 million as gross income from operations and $400,000 as a net loss from operations. This loss did not consider the agrarian debt payments due plus interest and refinancing charges. The $400,000 loss from operations amounts to about $200 per cooperative member. This is a significant amount when compared with the per capita income in El Salvador of $640 annually.

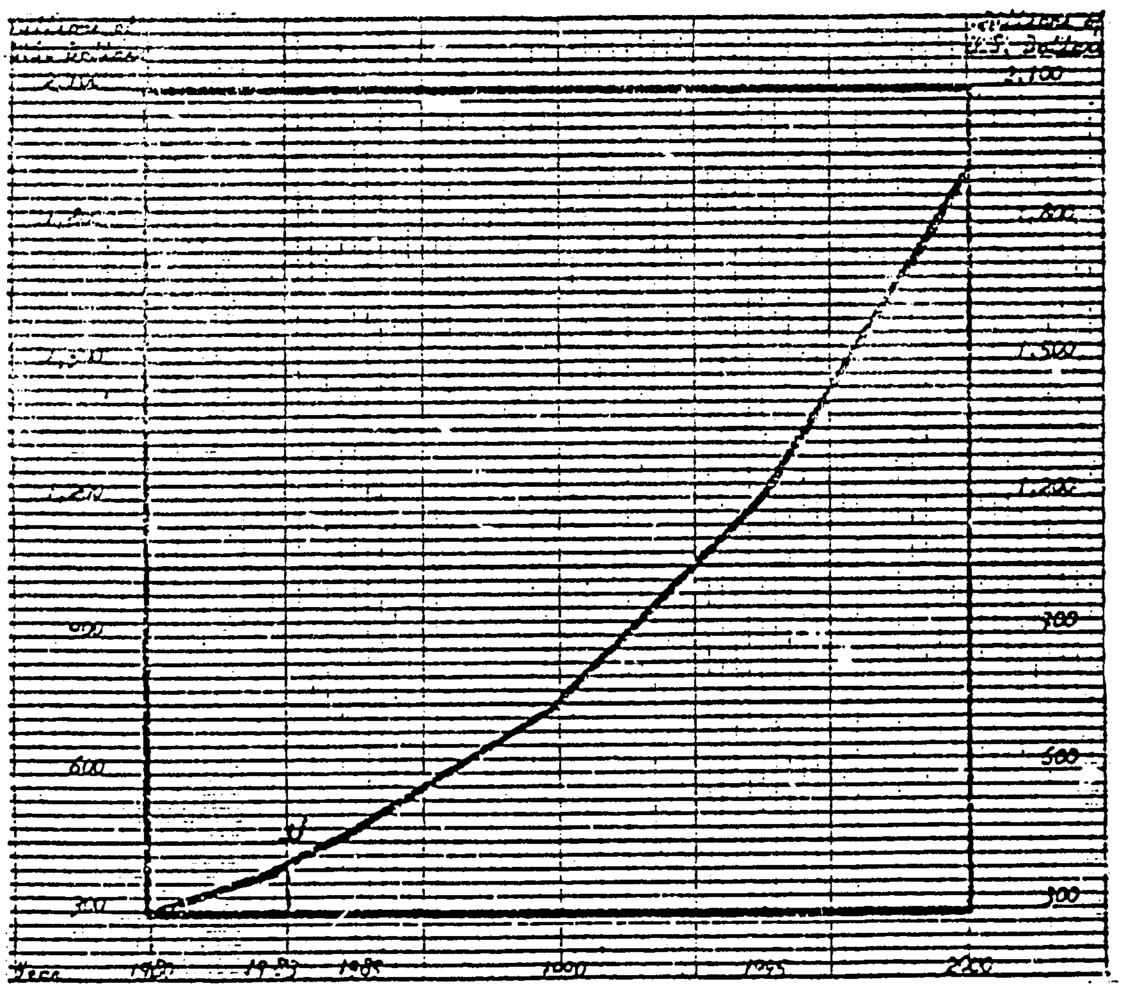
The agrarian debt for La Labor was estimated by ISTA at $6 million. Annual payments due on the capital debt were about $200,000 for a total of $600,000 due since inception of operations. The accumulated interest due on the agrarian debt totaled about $1.8 million. This unpaid interest should have been capitalized annually thereby increasing the amount due. In addition, La Labor owed about $315,000 for the 1980 emergency credits that had been refinanced and they had refinanced over $50,000 of production credits. (The La Labor cooperative's debts total over $10 million.)

During our field work at La Labor, ISTA's Regional Director told us that they have 11 traditional cooperatives and 87 Phase I cooperatives in his region. Of those 98 cooperatives, he said that La Labor was the best in his region in regards to potential and profitability.

Another example of the cooperatives' debt problems is the La Ceiba Phase I cooperative. About 98 percent of the cooperatives' 299 hectares was non-productive land. The estimated agrarian debt was about $114,000. Annual installments on the land which after three years totaled over $17,000 had not been paid. An additional amount due of more than $33,000 for interest on the agrarian debt had not been paid. Furthermore, this cooperative had to refinance the 1980 emergency credits of $12,000 and production credits of more than $10,000.

BFA credit agents required the members of La Ceiba to plant sugar cane on their productive land instead of the usual corn crop in order to receive their 1983 crop year production credit. BFA insisted on this requirement because, they said, La Ceiba would lose less money on sugar cane than they would on corn.

The agrarian debt plus compounded interest at 9.5 percent has resulted in a dramatic increase in debt of the cooperatives. If this process continues the debt could total about $2 billion by the year 2000.



1/ As of September 1983, the total amounted to about $400,000,000.

For most of the Phase I cooperatives as now structured there is little hope for becoming financially viable. The GOES believes that they do have a few Phase I cooper- atives that may work as now structured.

The office for Integrated Development of Agrarian Reform Enterprises (DIECRA), Ministry of Agriculture and Livestock (MAG) recently completed in depth studies on 51 Phase I cooperatives. Based on its studies, DIECRA concluded that (a) 9 of the cooperatives were viable operations; (b) 9 of the cooperatives may become viable after 6 to 12 years of operation; and (c) 33 of the cooperatives could not be made financially viable as structured. DIECRA pointed out, however, that their studies were based on the assumption that all conditions surrounding operations of the cooperatives would be ideal.

Our review of Phase I cooperatives included four of those studied by DIECRA. We visited three of those four cooperatives. DIECRA's studies on the three cooperatives included in our review concluded that two could not be made financially viable as structured and one of them may become viable after the sixth year of operation. Our review confirmed that the two cooperatives could not be made viable. We also agreed that the other cooperative may be viable in the future. However, we are not sure that that cooperative can be made viable without some debt forgiveness by the GOES.

There are several reasons for the poor performance of Phase I cooperatives. In addition to the overriding debt problems, the quality of land and excessive membership significantly affect the financial viability of these cooperatives.

Quality of Land

The poor quality of their land severely constrains the ability of most Phase I cooperatives to become financially viable entities. Of the 17 cooperatives we visited, only three had mostly productive land that could be cultivated. Three other cooperatives had land that was mostly acceptable for coffee trees. However, the remaining eleven cooperatives contained substantial amounts of land that could not be made productive without unrealistic investments of capital. Overall, 43 percent of the land in the 17 cooperatives was non-productive and most of the remaining land was of poor quality.

El Salvador has a total land area of 2,104,000 hectares 1/. The 1971 Census showed that a total of 1,451,894 hectares of land holdings were in farms 2/. Much of the land in farms, however, was not suitable for cultivation.

Approximately three-fourths of the country is mountainous with a wide range of serious problems with respect to the land base. The good agricultural land that does exist is mostly in the coastal plains of the southeast and the broad valleys of the west central part of the country. Smaller areas of good quality land are scattered throughout much of the country in the alluvial plains along the many rivers. Some of the soils on the hills and mountainsides are good quality but have special problems and limitations with respect to land use.

1/ National Geographic Institute: Atlas, 3rd edition, 1979 on El Salvador.

2/ According to AID's analysis of 1971 GOES Census.

The land resource in El Salvador was classified in 1974 by the Organization of American States into the standard land capability classes. That classification showed the following land base by capability class:

- 383,645 hectares in Classes I, II, and III. Land suitable for intensive crops. Good to moderate quality soils that could be mechanized and many of which could be irrigated if water was available.

- 128,410 hectares in Class IV. Medium quality soils suitable for limited cultivation but subject to erosion. Most require erosion control practices. Machine use limited by slope. Best for perennial crops.

- 385,000 hectares in Class VI 1/. Mostly very steep. Subject to severe erosion, already heavily eroded or rocky. Not suitable for intensive cropping. Adequate for perennial and tree crops, pasture and forest. Some might be used for cultivated crops on a limited basis with the use of terracing, strip cropping, diversion ditches, etc.

- 1,189,975 hectares in Classes V, VI, and VII 1/. Some of these (in Class V) are in coastal plains and not subject to erosion but require drainage, are subject to flooding, have a high water table or are too shallow to bedrock. Others (in Classes VI and VII) are steep, eroded, rocky, or have other limitations to the extent that bringing them into cultivation is impractical and not economical. These lands are suited for some forestry, pasture, and natural vegetation.

- 31,817 hectares in Class VII. Lands in this class are not suitable for any agricultural use. 2/

USAID/El Salvador in its Country Development Strategy Statement dated January 1979, presented data based on the GOES 1971 census showing that land under agricultural production in El Salvador totaled 932,716 hectares. That amount was the sum of the agricultural production areas identified as (a) temporary crops (488,436 hectares); (b) permanent crops (163,499 hectares); (c) improved pastures (112,737 hectares); and (d) native pastures and woodlands (168,044 hectares). The total land under agricultural production in El Salvador had remained basically constant for over 20 years as shown by the 1950, 1961 and 1971 censuses. The reason that the use of land for agricultural production in El Salvador had remained at less than one million hectares

1/ Some of Class VI land is usable for agricultural productive crops such as coffee trees due to its altitude, natural shade, etc. whereas Class VI land under other situations is usable only for timber, natural vegetation, etc.

2/ Total is 2,118,847. Difference of 14,847 hectares over accepted size of El Salvador (2,104,000) is attributable to lands disputed with Honduras.

over the long run is that the remaining land cannot economically be brought into production. Furthermore, the Organization of American States, as discussed above, determined that only 897,055 hectares of land in El Salvador was appropriate for agricultural production under USDA's standard land classification. Addition- ally, AID stated in their Janaury 1979 CDSS that problems with remaining lands are such that bringing them into cultivation is impractical and uneconomical.

In May 1980, however, USAID/El Salvador in its Agrarian Reform Sector Strategy Paper reported that El Salvador had approximately 1,450,000 hectares of land in farms. Of that farmland, about 662,000 hectares were in crops, 553,000 in pastures, and the balance in timber and other uses. El Salvador may have about 1,450,000 hectares in farms but it has only about 932,000 hectares of economically productive farmland that has normally been used for agricultural production purposes. Accordingly, we assessed the land in the Phase I cooperatives visited to determine whether it was productive. We found that much of the land on most of the 17 cooperatives we visited was poor quality land. In fact, much of the land in the Phase I cooperatives that we visited had never before been used for any agricultural purposes.

Based on the quality of land in the selected Phase I cooperatives we visited, it is apparent that many of the Phase I cooperatives were created from landholdings that included land other than agriculturally productive land. It's also apparent that ISTA did not properly consider the size of the farms and quality of the soil in relation to productivity and income in establishing cooperatives.

The data in the table below on the quality of land in the Phase I cooperatives are estimates. As previously discussed, accurate information on the agrarian reform activities was extremely scarce. None of the cooperatives visited had been surveyed by ISTA. Accordingly, neither ISTA nor the cooperatives knew the correct acreage or class(es) of their land.

However, many cooperatives had made plat maps of their farms showing productive and nonproductive land areas, and the uses they were making of the productive land. ISTA regional staff and co-managers on the farms had also developed data on land use and production. We reviewed the cooperatives' plat maps and land use data and compared them to ISTA's field staff data on land use and production. We then compared the cooperatives' and ISTA's data with land classification maps prepared by the Organization of American States. Based on these reviews, our observations, statements by cooperative members, and opinions or estimates of BFA field representatives, we developed the data presented in the following table. The estimates were conservative on the quality of land in the cooperatives. Much of the land visited classed as productive land probably would be assigned actual ratings of Class VI or poorer.

Landholdings of Selected Cooperatives

Cooperative	Land Area	Non-Productive Land	Productive Land	Percentage of Non-Productive Land
	HECTARES			
1. La Labor	2306	1014	1292	44
2. La Ceiba	299	294	5	98
3. El Refugio	628	112	516	18
4. Buena Vista	122	7	115	6
5. Tacachico	526	152	374	29
6. El Tatuano	127	56	71	44
7. Rancho San Marcos	362	196	166	54
8. Sta. Cruz Tazulath	2482	1097	1385	44
9. Veracruz	478	450	28	94
10. Santa Magdalena	135	9	126	7
11. Atapasco	274	56	218	20
12. El Zonte	851 1/-	-		
13. La Concordia	126	22	104	17
14. Las Mercedes	164	5	159	3
15. San Isidro	1048	594	454	57
16. Los Mangos	561	98	463	17
17. San Francisco Suchitoto	703	277	426	39
TOTALS	10,341	4,439	5,902	43

1/ This hacienda was listed as an ISTA "Traditional Cooperative". However, the cooperative had been disbanded and the land distributed to individuals in lots of from 6 to 37 hectares. We could not obtain a reasonable estimate on the class of land involved. But, it appeared to be some of the poorest quality land visited. This land is not included in the totals.

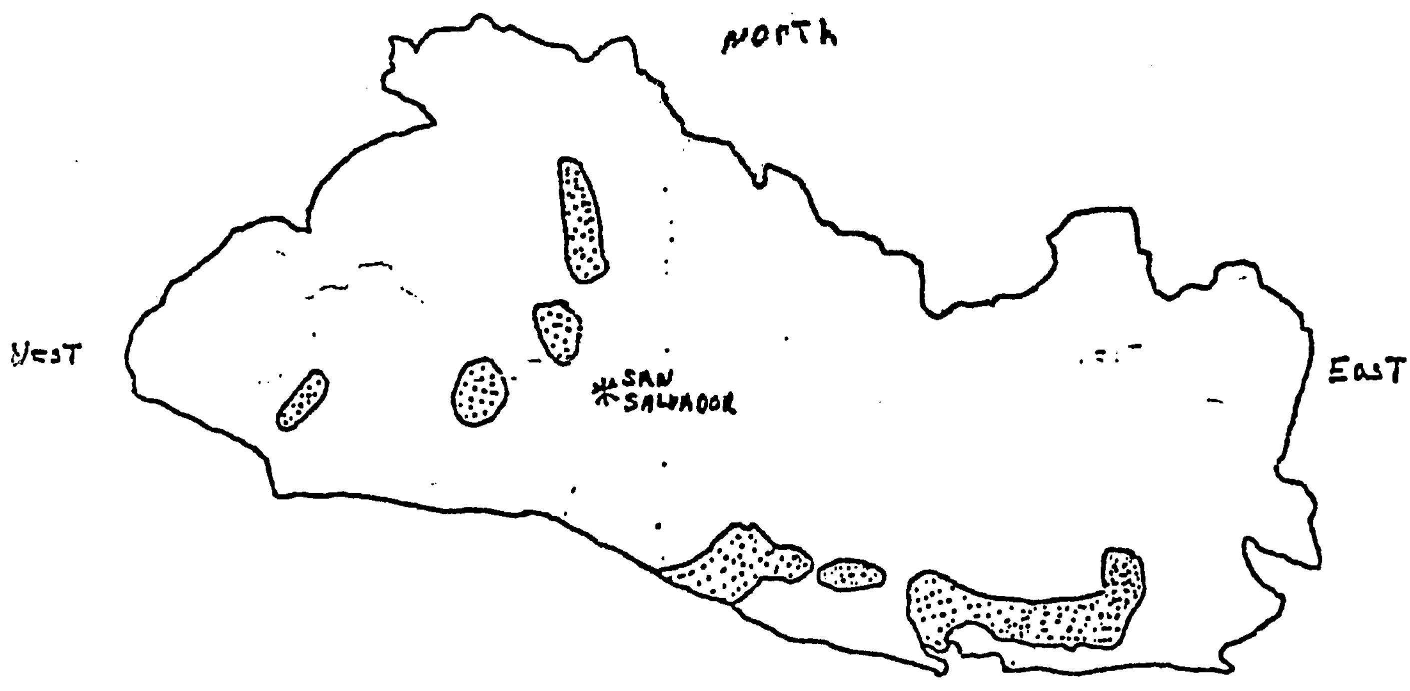
The Mission commented that El Salvador is land poor in terms of both quantity and quality of land, but the Phase I farms are located on much of the best land in El Salvador and many of these farms were profitable operations comparable in production to any in the world.

At our request, the GOES prepared a map of El Salvador showing the locations of the 317 Phase I cooperatives. We compared that map with land classification maps prepared by the Organization of American States (OAS). Based on that comparison, we estimated that over 75 percent of the Phase I cooperatives are located in areas of predominantly Class VI, VII or VIII quality land.

The OAS land classification maps show that the good quality cultivable land (Classes I, II, III and IV) in El Salvador is located in the west central and southeast coastal areas. When we compared the OAS land classification map with the GOES map showing the location of the 317 Phase I cooperatives, we found that only about 20 percent of the cooperatives were located in the areas containing the better lands. This estimate was corroborated by our visits to selected cooperatives.

While our physical verification of land quality was limited to western El Salvador, our comparison of the maps showed that most of the Phase I cooperatives in both western and eastern El Salvador are located in predominantly Classes VI and VII land areas. (See sketch map below.)

Our random sample of 10 percent of the Phase I cooperatives in the west, which contains 52 percent of the cooperatives and 55 percent of the land in Phase I, provides a solid basis for projection purposes for cooperatives located in the western half of country. This data, coupled with the information developed from comparing the cooperatives' locations and land classification maps strongly indicate that the finding on poor land quality in the west applies equally to those cooperatives in the eastern part of El Salvador.



1. Represents approximate locations of most of El Salvador's better quality lands (Classes I, II, III and IV). About 20 percent of the Phase I cooperatives are located in these areas.

2. About 75 percent of the land in El Salvador is classed as VI, VII, and VIII quality. About 80 percent of the Phase I cooperatives are located in areas predominantly of these classes of land.

Excessive Membership

Most Phase I cooperatives' memberships exceed the numbers needed to operate the farms on an efficient and effective basis.

Decree No. 153 provided that Phase I cooperative members would be exclusively campesinos who did not own land or who owned too little land to fulfill their basic needs. Preference was to be given to those campesinos who earned all or part of their income from the property prior to reform. Special legislation was to be issued to regulate selection criteria. But that legislation was not issued by the time the cooperatives were organized.

All the Phase I cooperatives visited during this audit had memberships larger than the number of persons reportedly employed on the land prior to the reform 1/. The larger memberships may serve short-term social and political purposes, but they compound the cooperatives' financial difficulties.

The Phase I cooperative La Labor demonstrates the membership difficulties. The pre-reform owner of La Labor had maintained for years about 2,000 full-time employees. These employees lived on and operated the farm. The owner also owned two other farms in the vicinity of La Labor. The La Labor "employees" also operated both of the other farms. La Labor contains about 2,300 hectares of land. The total land in the other two farms was about 2,800 hectares. The total land in the three farms that belonged to the previous owner was about 5,100 hectares.

All 2,000 employees lived on the La Labor farm so they could have the advantages of centralized services, e.g., schools, edical, social, housing, and water.

Under the agrarian reform program, the La Labor farm was organized into a Phase I cooperative. The La Labor cooperative now has about 2,100 members. These 2,100 members live on and operate the 2,300 hectare La Labor farm and there is not sufficient work for that number of people. Most of the members work only 2 or 3 days a week. Even though the membership has reduced their income, the farm is still not financially viable and cannot support that number of people.

Another example of the membership problem is the Rancho San Marcos Cooperative. This cooperative contains about 360 hectares of land. The land had previously been rented by a meat packing plant and had been used only as a holding area for cattle prior to slaughter. The farm contained about 160 hectares of improved pasture and 200 hectares of non-productive land. The operation previously had eleven employees. Now that the farm has been formed into a Phase I cooperative it has 56 members. They had converted 40 hectares of pasture land to cultivation and had 115 head of dairy cattle. BFA advised us

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1/ Membership in the cooperatives refers to individuals living and working on the property. The "official cooperative membership of record" may be considerably smaller in some units.

that this is the maximum number of cattle the land will support. However, the production was insufficient to pay for operating costs with a labor force of 56 members.

ISTA recently completed a study of the membership of 12 selected Phase I cooperatives. That study showed that membership in the cooperatives was more than twice the pre-reform number.

Other Areas of Concern

Several other areas were frequently mentioned by AID, GOES, and others as problems affecting the Phase I cooperatives' operations. Some of those problem areas were:

(1) lack of capable managers;

(2) lack of technical assistance;

(3) state of the worldwide economy;

(4) low productivity;

(5) the civil war; and

(6) lack of institutional capability.

The above problem areas probably adversely affect the operation and profitability of the Phase I cooperatives. For example, we noted that 40 of the 317 Phase I cooperatives reportedly had been abandoned due to the civil disturbances. Nevertheless, the land will only produce so much and support so many people without regard to these additional reported problems. Until the land productivity, capital investment, debt structure and labor force are brought into some kind of equilibrium, efforts to deal with these additional problem areas will not be successful in making most cooperatives viable.

USAID/El Salvador officials agree that the main problem with the Phase I cooperatives is their weak financial condition. They also agree that the agrarian debt is one of the major reasons for the cooperatives' lack of financial viability. USAID/El Salvador officials, however, disagree with our position that the poor quality of land is one of the main reasons for the Phase I cooperatives' poor financial performance. The Mission believes that the cooperatives have good quality land, and that their yields are high. The Mission is of the opinion that the lack of adequate management is the main reason for the cooperatives' poor financial performance.

Phase II

Phase II of the agrarian reform program has not been implemented.

Phase III - Land to the Tiller

Phase III, which authorized the expropriation and sale of land to renters, has begun to achieve results with over 25,000 applicants receiving and tilling land purchased under this program.

By the summer of 1983, over 63,000 applications had been filed by about 50,000 individuals for land under Phase III authority. Most of the applications were approved. Recipients who were working the land were in a position to substantially improve their economic and social positions. Thus, these recipients had a vested interest in the program continuing and in the government that provided the program.

Yet, more needs to be done because the negative side of the program shows that less than one-half (about 50,000 out of an estimated 117,000) of the individuals eligible for property under Phase III had filed applications to purchase the land. And about one-third of the applications filed did not result in the applicants working the land. They were not working the land because they had been threatened, evicted or had disappeared.

Phase III of the agrarian reform program was initiated on April 28, 1980 by Decree No. 207. Sections of that Decree follow:

> "The purpose of this law is that the State acquire land holdings which are not being directly exploited by their owners, in order to assign them to the persons mentioned herein, who from now on shall have preferential rights to acquire said land holdings and become their rightful owners. Therefore, landholdings or portions of same -- appropriate for agricultural exploitation and regardless of their size -- which at the present time are being exploited by simple lessees or by persons holding lease contracts with an option-to-purchase clause, sharecroppers, contract purchasers with ownership rights over the property, or other persons who work the land directly -- through payment either in cash or in goods -- are hereby expropriated.
>
> "Beneficiaries who, in accordance with this law, have been assigned land plots by ISTA 1/, shall be entitled to own a maximum of seven hectares.

1/ Decree No. 525 of December 11, 1980, created FINATA and provided that FINATA replace ISTA as the implementing agency for Decree No. 207.

"When expropriated landholdings or land plots exceeds seven hectares, the excess land shall continue to be ISTA's property, who should respect the rights of the lessee or other person working the land during the current agricultural year, and assign it to other beneficiaries after the end of the harvest season. This seven hectare limit shall not be applied to persons holding a lease contract with an option-to-purchase clause, or to contract purchaser with ownership rights who has acquired such property or land plot through a legal instrument, before the present law became effective"

The GOES in 1980 estimated that 160,000 persons were eligible to receive land under Decree No. 207 authority. That estimate has been revised downwards several times and in July 1983 stood at 117,000 persons. The implementation period of the program under Phase III has been extended three times and now will expire on June 30, 1984. As of March 31, 1983, about 50,000 individuals had filed 63,496 applications requesting approval to purchase land in accordance with Phase III authority. 1/

To evaluate the effectiveness of Phase III we decided to interview individuals who participated in the program. The most reliable universe data on the program was the application for purchase of land under Phase III authority maintained by FINATA. Accordingly, to determine the results of the applications filed and the status of the individuals who filed the applications, we selected and reviewed a random sample of 149 applications from a computer listing of the total of 63,496. We visited or attempted to visit and interview the individuals who filed the 149 applications. Individuals we could not locate in secure areas were officially summoned by the government so we could interview them. If the individuals did not answer the summons, FINATA officially searched for them and provided a status on the individuals. In most cases where the applicants did not answer the summons, FINATA found that they no longer lived in the area and their whereabouts and condition were unknown. Based on the results of this sample, we have estimated that of the 63,496 applications filed:

- About 15,000 or 23 percent of the applications were for lands that at the time of audit were inaccessible due to security reasons,

- About 25,000 or 39 percent of the applications resulted in the applicants receiving and using the land,

- About 20,000 or 31 percent of the applications had not resulted in the applicants acquiring and having use of the land. This number includes applications that were not approved, applicants who no longer lived in the area, applicants who had been evicted, etc.

1/ FINATA reported that as of December 25, 1983, they had received 75,967 applications from 60,733 individuals. FINATA also reported that by the same date they had issued 55,287 provisional and 5,456 definitive titles under Phase III.

About 6,000 or 9 percent of the applications had resulted in the applicants being illegally evicted and not reinstated (this amount is included in the 31 percent above).

The sample size 1/ in this review was small and therefore the sampling error for an estimate of 31 percent is plus or minus 7 percent at the 95 percent confidence level. That is, the estimate of 31 percent has a 95 confidence interval of about 24-38 percent. Accordingly, the sample gives a 95 percent confidence level that the maximum deviation downward from our actual finding of 31 percent (20,000) would be 24 percent (15,000), and the maxium deviation upward from the sample's 31 percent is 38 percent (25,000). Similarly, the estimate of 9 percent from the sample has a 95 percent confidence interval of 5-13.

However, the actual number of the Phase III recipients not working the land and who had been evicted probably is greater than that shown by our estimate because there is a high probability that land owners and guerrillas alike in the insecure areas are not enforcing the El Salvadoran Government's Decree No. 207 (Phase III).

1/ In their comments on the draft report, the Mission referred to a CPA firm's study made for the auditors. We had reviewed that CPA firm's study and dismissed it as being statistically invalid because the CPA firm deviated from the pre-established scientific sample.

VI. REVIEW OF THE AGRICULTURAL DEVELOPMENT BANK (BFA)

BFA was founded in 1973 for the purpose of increasing the flow of credit to the agricultural sector, particularly to the small farmers who previously had no access to institutional sources of credit at competitive interest rates. Until the agrarian reform was initiated in 1980, the BFA performed these functions well. The capital position of the bank was strong.

With the initiation of agrarian reform, demands for credit expanded enormously. From December 1979 to September 1982, BFA's loan portfolio increased from $56 million to $176.4 million, over a threefold increase. This increase in lending activities strained the Bank's resources causing high operating costs, low rates of recuperation, and inadequate loan supervision. As a result, BFA's financial condition was precarious. The delivery and supervision of agricultural credit to the Bank's agrarian reform clients was less than satisfactory. It appears that the Bank's financial position improved during 1983 due to the infusion of AID funds, improved rates of loan collections, and actions by the GOES. The Bank's financial position, however, still is a matter of concern.

Through March 31, 1983, $29 million of AID funds had been authorized for use by the BFA. BFA transactions and procedures disclosed several problems impeding the effective delivery and administration of credit to agrarian reform beneficiaries. In addition, $1.4 million of AID funds were used for unauthorized purposes.

Background to Credit Component

Before the agrarian reform program, few beneficiaries either had access to or had availed themselves of institutional credit. Phase I beneficiaries were primarily wage laborers on the large haciendas. The previous owners of these haciendas received production loans from the commercial banking system. Longer term funding was obtained most often from either the haciendas' own capital resources or from external loans.

A Decree No. 207 (Phase III) beneficiary who rented his land had access to BFA credit through a note provided by the owner of the rental property certifying the type of crop produced and the total acreage planted. As a result of agrarian reform, affected Phase I property owners lost access to traditional credit channels and more Decree No. 207 beneficiaries were expected to use institutional credit sources.

When Decree No. 153 was implemented, the GOES' primary concern was to maintain production from the affected properties. ISTA was assigned responsibility for organizing beneficiaries into functioning production units and for supplying the units with sufficient production credits to continue farm operations. During the start-up phase of the program (March - September 1980), $47.2 million in emergency credits were disbursed by BFA through ISTA to the Phase I beneficiaries.

In order to facilitate the continuous availability of credit, the GOES in August 1980 divided responsibility for providing credit between the various banking institutions. BFA was assigned 92 of the Phase I cooperative farms (currently 111) and Phase III recipients. AID in September 1980 authorized BFA an initial $9.5 million in loan funds to be disbursed to the cooperatives through a special line of credit, and an initial $500,000 in grant funds to provide technical assistance relevant to BFA's new responsibilities. Later, an additional $3.3 million in loan funds for credit was authorized.

In response to the increased demand for credit resulting from the reform, AID authorized an additional $17 million in loan funds during 1981: (a) $16.2 million for the creation of an integral line of credit to replace the established special line of credit; (b) $600,000 for institutional building support in the form of additional technical assistance and equipment; and (c) $200,000 for an Integrated Pest Management Program.

Credit Component Results

Much progress has been made in delivering and administering credit to Phase I and Phase III beneficiaries. The $29 million of AID loan funds authorized for credit had been disbursed by BFA to agrarian reform beneficiaries. Approximately 76 percent of the funds were used for production credit and 24 percent for investment credit. About 50 percent of the credit was used to finance agricultural inputs for producing basic food grains, i.e., corn, rice, beans and sorghum. The longer term credit was used to purchase livestock or for improving farm infrastructures. The remainder financed the production of some of the major export crops.

Although much progress had been attained, the administration and delivery of credit and related services to agrarian reform beneficiaries continues to be beset by technical and administrative problems that have limited the effective use of AID funds.

Most of the problems affecting the delivery of credit can be attributed to insufficient institutional capability.

Insufficient Institutional Capability

The Agricultural Development Bank of El Salvador (BFA) has not been able to cope with the added burden and responsibilities created by agrarian reform. BFA was to provide adequate and timely credit to Phase I cooperative farms and Phase III beneficiaries in order to facilitate achievement of program goals of improving the economic and social well-being of the agrarian reform beneficiaries. Although BFA has been reorganized, the restructuring process is not complete. As a result, BFA has not been able to effectively carry out its assigned role. Three major problems affect the Bank's operation:

- High operating costs;

- Poor rate of loan recuperation; and

- Weak fiscal, accounting and credit management controls.

High Operating Costs

Since the start of the agrarian reform, BFA's administrative costs have increased by about 43 percent, from $6.2 million to $8.8 million. Financial costs have risen at an even faster rate, about 250 percent, from $3 million to $10.6 million for the same period.

BFA finances its operations primarily from earnings generated by its two principal activities, banking and commercial sales of agricultural inputs. In order to meet the increased demand for credit, BFA was forced to increase its use of high cost Central Bank (BCR) discount lines. In 1978, BFA financed 42 percent of its loan portfolio by borrowing from BCR. By 1981, that percentage had increased to 67 percent. The cost of short-term borrowing increased from $1.1 million in 1978 to $10.6 million in 1981, a ninefold increase. During the same period, BFA's income from interest earnings grew by slightly more than twofold. As a consequence of higher operating costs, both financial and administrative, net losses from banking operations increased from $1.5 million in 1978 to $3.5 million in 1981.

In spite of the progress attained to date, BFA's current financial condition continues to be weak and vulnerable. A lot more needs to be done in order to enhance the Bank's financial viability. Foremost, BFA's banking operation must become cost efficient.

Loan Recuperation

BFA has not been able to establish and implement an effective management and reporting system for its outstanding loans. Thus, delinquent and uncollectible loans present BFA with serious financial management problems which substantially contribute to higher operating costs and overstatement of the Bank's financial condition.

BFA's loan recuperation has been poor. Progress has been made toward improving the rate of loan recuperation, which in 1980 stood at 40 percent. But the projected rate of 76 percent for the crop year 1983/84, even if attained, will be too low to help assure future financial stability.

BFA does not have a write-off policy and its uncollectible debt is listed on the books as simply overdue. For example, as of September 30, 1982, of an outstanding balance of $128.7 million, $22.9 million, or about 18 percent was more than 360 days overdue. This practice results in an overstatement of the Bank's equity capital because some of these loans are uncollectible and are really not assets of the Bank. An independent analysis of BFA concluded that if BFA's balance sheet was adjusted to reflect the overdue accounts, equity capital would be reduced by $48.4 million. The rate of loan recuperation must be raised if BFA's operations are to be improved.

Management Controls

BFA's internal management policies and the system of accounting and internal controls have not been adequate to meet the additional responsibilities of the agrarian reform program. As a result, BFA's financial condition has suffered and effective project implementation has been impaired.

BFA lacked an effective and uniform system of accounting and internal controls. Posting to books was not current; accounts were not timely reconciled; and there were serious bottlenecks affecting the flow and analysis of accounting data. As a result, BFA's financial position and the results of its operations could not be clearly determined. For example, although all AID-provided funds had been disbursed, BFA's Accounting Division was unable to provide us in October 1983 with a financial statement of AID funds as of the cut-off date of our report, March 31, 1983. Instead, we were given a qualified statement for December 31, 1982. The reasons given to us for not having the data readily available was that BFA was behind in its posting and the accounting division was still trying to review and reconcile the data received from branch offices and its data processing division.

BFA's system of internal controls does not ensure adequate use and accountability of resources.

Due to the dramatic increase in business, BFA's system of internal controls had become ineffective. As a result, the review of loan data from branch offices was inadequate and administrative bottlenecks had developed which affected the timely analysis and supervision of activities.

We found little coordination for the review and analysis of data submitted by BFA branch offices. Revisions were made by the various BFA headquarters divisions without the proper adjustments and reconciliation. In some instances, each division had a separate set of figures. For example, during our review of AID funded subloans, we were unable to reconcile the data furnished to us by the AID coordinating office, the branch offices or the accounting division.

This lack of adequate management control has prevented BFA from exercising more effective and timely control over the use of its resources.

Data Processing

BFA's data processing system was obsolete and produced such untimely and inaccurate results that it had no management utility. A recent study of BFA's information processing requirements conducted by a computer expert found, among other things, that the BFA system had (1) limited accessible memory; (2) cumbersome input/output procedures; and (3) no interactive programming capability.

The consultant's report was reviewed by AID which agreed with the consultant's recommendations to procure and install a new system. As a result, AID funds were set aside to conduct a thorough systems analysis, to procure and install the new computer system and to provide for the training of operators and programmers. Notwithstanding, the availability of funds to do the system analysis, little progress had been made to identify and contract with technical personnel. We were unable to clearly establish the status of the procurement of the data processing system.

Unauthorized Use of AID Funds

Approximately $1.4 million of AID funds were used by BFA for unauthorized purposes.

Under the terms of the agreement between AID and the GOES, loan funds provided to BFA must be used for production related activities incurred after June 28, 1980.

Proceeds from AID funded subloans, however, were used to liquidate a portion of the emergency credits granted to some cooperatives at the start of the agrarian reform program. Bank officials said that the decision to use AID funds to liquidate portions of the emergency credit was made in light of the severe liquidity crisis that BFA was experiencing at the time as a result of the start-up demands of the agrarian reform program.

Records related to 44 cooperatives showed that $1.356 million of the proceeds from the first AID funded subloans were used to refinance portions of the emergency credit instead of being used for production related activities. Although we understand the reasons that prompted BFA in their decision on the initial use of AID funds, that use was specifically unallowable by terms of the loan agreement.

The pertinent AID agreement specifically limited payments to activities initiated on or after June 28, 1980. Accordingly, we recommended that USAID/El Salvador recover the AID funds which were used to refinance ISTA emergency credits provided to Phase I cooperatives before June 28, 1980.

Recommendation No. 1

USAID/El Salvador recover $1,356,056 used by BFA for unauthorized purposes.

Financial Viability of BFA and its Cooperatives

The financial condition of BFA is inextricably linked to the debt structure of its agrarian reform beneficiaries, particularly the Phase I cooperatives and the ability of these farm operations to generate sufficient revenue to repay their debts and to provide income for their members. Most cooperatives are not financially viable operations and, therefore, don't generate sufficient revenues to pay their debts to BFA. BFA must depend on payments from these cooperatives to ensure its own financial viability.

The majority of the Phase I cooperatives carry four kinds of debts:

1 Agrarian reform debt, which for all Phase I cooperatives is estimated to be $300 million in compensation to the former owners for the value of land, buildings, equipment and improvements. The payment schedule for these mortgages is 20 to 30 years, and the debt bears interest charges of 9.5 percent per annum. Only meager payments have been made on this debt by a few cooperatives.

2. The ISTA/BFA portfolio or emergency credit, totaling $10.4 million for BFA cooperatives. These credits have been controversial for many cooperatives. As a result, repayments have been limited even when cooperatives had the funds to pay.

3. Short-term production credit. Demand of BFA's cooperatives for short-term production credit for the 1983/1984 crop year was expected to reach $23.2 million. Many cooperatives have experienced difficulties in repaying their production credit. The unpaid production credits oftentimes were refinanced thereby increasing the debt and leaving the cooperatives little or no capability for further borrowing.

4. Other credits from outside the financial system, such as savings deposits by members or purchases financed directly by suppliers or agribusiness firms. Because of the lack of records, the amount of this debt could not be estimated.

The effect of the debt burden is demonstrated by the projected credit and revenue figures for the cooperatives assigned to BFA for the 1983/84 crop year. BFA estimates that these cooperatives will produce a harvest valued at approximately $25.7 million. This harvest, combined with residual previous year's export crops in storage and valued at $2.1 million, will provide gross income of $27.8 million. Production and investment credit debt for the year was estimated to be $23.2 million resulting in a projected gross profit of $4.6 million, which is to be used to reduce the outstanding production and investment debt of $16.4 million, carried over from the previous years. Thus, even if the projected excess revenues could be realized, BFA cooperatives would have at the end of the 1983/1984 crop year, outstanding production and investment credit debts of about $11.8 million. It should be pointed out that BFA projections did not take into consideration expenditures resulting from other operating costs; interest and principal payments due on the agrarian debt and other debts incurred outside the financial system.

A major problem for the cooperatives is the lack of effective management and record keeping which prevents the farms from realizing better returns on their resources. Complicating the repayment problem are depressed prices for their commodities and the civil strife being experienced in the country. Finally, the technical assistance and training so important for increased production and income have not been forthcoming from the responsible GOES agencies.

The results of accumulated overdue debt are threefold: (1) financial institutions (mixed banks) are reluctant to continue granting credit to levels required by the cooperatives; soon most of the cooperatives may be assigned to BFA, (2) it is becoming increasingly difficult for members to see the day in which they will be making profits and enjoying the benefits of land ownership, and (3) BFA's financial condition will continue to deteriorate due to the high rate of uncollectible loans and continued high operating costs.

The emergency credits (ISTA/BFA portfolio), for example, appears to be a controversial matter for most of the cooperatives. Many cooperatives received emergency credits at the start of the program. Unfortunately, neither ISTA, BFA, or the cooperatives had a system of adequate controls and loan supervision. There have been accusations of inefficiency or wrongdoing and allegations that many cooperatives never received all of the emergency funds loaned to them. Thus, many cooperatives refused to repay the loans even when they had available funds. In some other instances, natural disasters such as the drought and floods of 1982, or civil disasters such as the cases where cooperatives' members had to leave their lands due to the civil strife had contributed to the cooperatives' precarious financial condition.

Unable to pay for the production credits, cooperatives refinanced these outstanding debts in order to secure credit for the next crop season. The added debt not only increased the financial burden, but it limited the cooperatives abilities to obtain medium and long-term credit.

There is concern among GOES officials about BFA's financial viability. BFA is an agricultural development bank mandated to service credit needs of a clientele that consists of high risk, marginal, and small producers. Servicing a clientele of that nature requires considerably more supervision than the clientele of commercial banks. Commercial banks enjoy much more latitude in selecting clients and the type of activities they elect to finance. This servicing has resulted in expensive operating costs and a high rate of delinquent and uncollectible loans which have presented BFA with serious financial management problems since the start of the agrarian reform program.

For example, the administrative cost of managing each loan in 1981 was $195; this compares with a cost of $126 in 1979. The interest spread between what BFA receives from its lending operations and what the bank pays for deposits, funds, etc., was a negative 1 percent for 1981. The spread between what the bank receives from its lending operations (average 6 percent) and BFA's total cost (average 11 percent) was a negative 5 percent.

A consultant's review of BFA estimated that 33 percent of the loan portfolio was uncollectible. In addition, about 20 percent of the loans classified as non-delinquent had hidden delinquencies, i.e., loans that were partially delinquent but classified by BFA as current.

In sum, the increase in business resulting from the agrarian reform has put BFA in a weak and vulnerable financial position.

The need to complete the Bank's restructuring process and the necessity to bring the Bank's operation to an acceptable level of efficiency and cost effectiveness cannot be overemphasized. It must be done. Although BFA has made some progress in improving its financial position and reducing its operating costs, a lot more needs to be done if BFA is to survive as one of the GOES's main vehicles to support the agrarian reform program.

In their comments on the draft audit report, USAID/El Salvador agreed that the agrarian reform undertakings have overtaxed BFA's resources, weakened its capital structure, and brokendown its internal control system. However, the Mission claimed that these problems improved significantly in 1983 based on some unidentified sources financial projections. They also expressed concern that the draft audit report did not adequately present the progress attained in overcoming the problems.

We agree that the USAID has provided substantial assistance to BFA and that the Bank would have been in much worse condition without the assistance provided. AID assistance should further improve the Bank's operations and thereby, in time, its capital position. However, since BFA had not been able to close its books for calendar year 1982, and, as of October 1983, was still trying to establish and identify its delinquent accounts for the period from 1980 to date, we cannot place much credence in financial projections for calendar year 1983.

In the Mission's opinion, the BFA's financial condition to date is stronger than it was prior to the inception of the agrarian reform program. To support its opinion, the Mission submitted three tables with condensed financial data for the period 1978 through October 1983. We were unable to ascertain the reliability of the data submitted because it was too condensed, and its source unknown. However, we noted considerable difference with audited and adjusted data available at BFA and with the results of the evaluation made by AID consultants. For example, according to the Mission's estimates, BFA losses from banking operations for 1982 were only $2.8 million. This drastically contrasts with AID's consultant's estimated loss of $10.2 million.

VII. COMPLIANCE WITH FUNDING RESTRICTIONS

AID has developed an unusual and complicated system to provide the GOES approval for their use of Economic Support Fund generated local currency. This process, however, does not appear to violate Section 730 of the Foreign Assistance Act. ISTA, on the other hand, contrary to agreements with AID, has used $2 million from P.L. 480 generated local currency for payment of compensation to previous owners of expropriated properties.

The Foreign Assistance Act of 1961 as amended by the International Security and Development Cooperation Act of 1981 restricted the use of AID assistance to El Salvador. Section 730 of the Act (P.L. 97-113) commonly referred to as the Helms Amendment;

> required that none of the funds authorized to be appropriated by this Act may be made available for the provision of assistance to El Salvador for the purpose of planning for compensation, or for the purpose of compensation, for confiscation, nationalization, acquisition, or expropriation of any agricultural or banking enterprise, or of the properties or stock shares which may be pertaining thereto.

AID and the GOES have entered into an Economic Support Fund Grant Agreement, Memoranda of Understanding and several amendments to each of the documents. Simply expressed, these agreements say that the GOES will create a special permanent fund from GOES resources to be used exclusively for paying compensation to those affected by the agrarian reform program and AID will provide the GOES over $200 million in Economic Support Funds. The Economic Support Funds will be used to finance imports from the U.S. for the GOES and the local currency generated from those funds will be used to support the budget of the GOES. The local currency funds are commingled in the central bank accounts; are used to provide general support of the GOES budget; and, are not traceable to specific uses.

The use of Economic Support Funds to support the GOES budget if they will in turn pay compensation to previous land owners from other funding sources appears technically proper and not in violation of the Helms Amendment.

USAID/El Salvador employed a Salvadoran Certified Public Accounting firm to make financial reviews of selected AID funding. As a result of one of those reviews, the firm reported in February 1983 that ISTA has used $2 million to pay compensation for property acquired under the agrarian reform program.

The funding source for the $2 million used for compensation was from P.L. 480 generated local currency. Thus, the use of these funds to pay compensation did not violate the Helms Amendment which applies to funds appropriated for the Foreign Assistance Act. However, the use of the funds was in violation of the Project Agreement between AID and the GOES. Accordingly, USAID/El Salvador had taken action to recover the funds used to pay compensation. The Mission reported that $1 million of the funds had been recovered and the remainder should be returned in the near future.

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