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USAID/EL SALVADOR

FY 1994 ESF

MODERNIZATION OF THE STATE PROGRAM

CONCEPT PAPER

March 17, 1994

LIST OF ABBREVIATIONS AND ACRONYMS

(Alphabetical Order)

APSISA	Support to the Health Systems
ANEP	Private Enterprise National Association
CAESS	San Salvador Electric Light Company
CAPS	Central American Peace Scholarships
CEL	Hydroelectric Commission for the Lempa River
CENITEC	Technical and Scientific Investigation Center
CEDEM	Center for Democratic Studies
CLUSA	Cooperative Liaison of the U.S.A.
CNFPS	Consolidated nonfinancial public sector
CRECER	Rural Equitable Economic Growth
EDUCO	Education with Community Participation
ESAF	El Salvador Armed Forces
ESF	Economic Support Fund
FEPADE	Foundation for Entrepreneurs for Educational Development
FIS	Social Investment Fund
FMLN	Farabundo Martí National Liberation Front
FUNDAUNGO	Dr. Guillermo Manuel Ungo Foundation
FUNDE	Economic Development Foundation
FUSADES	Salvadoran Foundation for Economic and Social Development
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GOES	Government of El Salvador
HIID	Harvard Institute for International Development
IBRD	International Bank for Rural Development (World Bank)
IDB	Interamerican Development Bank
IMF	International Monetary Fund
ISL	Investment Sector Loan (Interamerican Development Bank)
ISSS	Salvadoran Social Security Institute
MEA	Municipalities in Action
MOE	Ministry of Education
MOH	Ministry of Health
MPHS	Multipurpose Household Survey
NCBA	National Cooperative Business Association
NGOs	Non-Governmental Organizations
NRP	National Reconstruction Program
ORS	Oral Rehydration Salts
PAHO	Pan American Health Organization
PNC	National Civilian Police
SABE	Strengthening Achievement in Basic Education
SAL	Structural Adjustment Loan (World Bank)

SILOS	Local Health Systems
TA	Technical Assistance
UCA	José Simeón Cañas Central American University
UNICEF	United Nations Infant and Child Emergency Fund
UNFPA	United Nations Fund for Population Activities
USG	United States Government
VAT	Value added tax
WHO	World Health Organization

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I- SUMMARY AND CONCLUSIONS

This document presents the Mission's proposed FY 1994 ESF Modernization of the State Program. The proposed program is designed to support GOES actions to reduce poverty through well-focussed measures to modernize the state, and, in particular, improve the social service delivery system. Two disbursements are proposed to support GOES measures to expand the coverage and enhance the quality of basic education and primary health services, and accelerate municipal development. In addition, the proposed program supports other measures targeted toward relieving remaining important constraints to sustained economic growth.

Over the last few years El Salvador has gone through a major transformation. On January 16, 1992, the GOES and the Farabundo Martí National Liberation Front (FMLN) signed a peace agreement in Chapultepec, Mexico, which brought an end to El Salvador's 12-year civil war. Since then, the FMLN has demobilized its 8,500 ex-combatants, the military has been cut in half from 60,000 to 30,000 members, and an unprecedented purging of the top 100-plus military officers has been completed successfully. A new National Civilian Police Force has been established and, as new police officers complete training, is gradually being deployed around the country replacing the former National Police Force under military control. A United Nations-negotiated land transfer program has provided 94,000 acres of land to FMLN and ESAF ex-combatants. Hundreds of thousands of ex-combatants and civilians in the formerly conflictive areas of the country have been documented and registered to vote for the upcoming March 20 national elections. In addition, major judicial, electoral and human rights reforms have been implemented including a new electoral code, the creation of a more representative National Council of the Judiciary, a new law guaranteeing individuals the right to public defense, the strengthening of the Supreme Electoral Tribunal, the establishment of a new Human Rights Ombudsman Office, the civilianization and integration of the Special Investigative Unit into the National Civilian Police (PNC), and the submission to the Legislative Assembly of modifications to the labor code which, when enacted, will strengthen the protection of internationally recognized worker rights.

Although the road has not always been smooth and many challenges remain, the peace process has proceeded remarkably well. The cease fire called for by the Chapultepec Accords has remained intact, and relatively few incidents of political violence have been reported. On December 15, 1992, the United Nations Secretary General declared El Salvador's war officially over.

After the peace accords were signed, the GOES initiated implementation of a $1.4 billion national reconstruction program designed to assist in the demobilization of ex-combatants, the rehabilitation of the country's war-damaged infrastructure, the reintegration of the formerly conflictive areas into the national economy, and a major extension of social services into the ex-conflictive zones. To date, the National Reconstruction Program (NRP) has provided various forms of assistance to over 100,000 beneficiaries. This progress has been instrumental in the successful consolidation of peace and democracy in El Salvador. It has also contributed importantly to El Salvador's continuing economic expansion.

The country's economic recovery actually predates the end of the war. A comprehensive economic reform program initiated in 1989 has been highly successful in reorienting the economy toward more reliance on market forces and a competitive private sector. The program has resulted in four years of accelerating real economic growth, lower inflation, improved fiscal performance, major gains in investment, substantially higher employment, and increases in nontraditional exports which have contributed to a stronger overall balance of payments position, i.e. net international reserves have increased sharply. In addition, the urban unemployment rate has been reduced and urban poverty rates have declined, albeit only modestly.

These economic gains, which materialized well before the end of the war, should be considered a major factor contributing to the achievement of peace in El Salvador. The economic gains clearly visible in 1990 and 1991, along with greatly improved economic prospects for 1992 and beyond, helped set the stage for successful negotiations. Both sides realized that demobilization of forces and their reintegration into an expanding national economy would be much easier than during a period of economic stagnation or decline. Thus, while consolidation of the peace process has indeed increased investor confidence and contributed to improved economic performance, it is also the case that the positive gains resulting from the economic reform program initiated in 1989 helped achieve the peace in the first place.

As El Salvador looks to the future, several challenges remain. First, notwithstanding the remarkable achievements to date, the nascent peace in El Salvador must be vigorously protected and the democratic process strengthened. Elements still exist in Salvadoran society which prefer to use violent means for conflict resolution rather than democratic, legal and judicial processes. A surging crime wave threatens public security and complicates the transition to a civilian police force.

Although impressive gains have been registered, El Salvador's economic recovery remains fragile as the policy reforms implemented in recent years have yet to be fully consolidated. Moreover, notwithstanding four consecutive years of solid economic growth, in real terms per capita income is only equal to 83 percent of that achieved in 1978. Although experiencing some noteworthy growth in recent years, the value of El Salvador's exports in 1992, when adjusted for inflation, are equal to only 29 percent of that recorded in 1979, the country's peak year for exports. El Salvador's trade deficit, while for the time being financed by surging family remittances and official grants and loans, has reached a troubling 17 percent of GDP in 1992. Although marked improvement in the fiscal accounts was observed in 1993, fiscal performance continues to be the Achilles heel of the Salvadoran economy.

Some modest progress has been achieved over recent years in many social/poverty indicators. The economic reforms in El Salvador have resulted in improved incentives and greater opportunities for lower-income groups to be more productive and thereby increase their incomes. Moreover, the GOES social measures in recent years, financed largely by the USG and other international donors/lenders, have provided an important cushion to vulnerable groups during the economic adjustment process. Also, the recent surge in family remittance inflows, encouraged by exchange rate and financial market liberalization, has had a major favorable impact on the poor.

Nonetheless, poverty remains a major problem in El Salvador, and represents a major threat to the consolidation of peace and the strengthening of democracy. The high rate of poverty also contributes importantly to the country's deteriorating crime situation. Up to 50 percent of El Salvador's population still lives in poverty. Access to essential education and health services required to both improve the quality of life and better equip low-income Salvadorans to take advantage of the greater opportunities made available by the expanding economy is grossly insufficient.

Therefore, while it is still important for the GOES to continue its program to further liberalize its economy and permit markets to work, it must now place added attention on direct measures to more effectively combat poverty. Reaching close to 100% coverage of basic health and primary education services of a minimum level of quality would be an achievable goal in five to ten years if more resources were spent and if the internal efficiency of public institutions were increased markedly. Increases in efficiency, however, could only take place with a significant modernization of public institutions in the health and education areas, and this would require the decentralization of government functions and a greater role for NGOs and the private sector in the provision of social services. Some of the key constraints to broadly-based economic growth are summarized below.

The key ministries providing social services (Health and Education) are overly centralized, and this does not allow citizens any degree of control over those services. The line ministries have low levels of internal efficiency which are manifested, for example, in the low level of attendance by teachers (absenteeism may be up to 40% in the rural areas). Their personnel management systems are based on archaic hiring processes and contain no incentives for improved performance. There is too much reliance on foreign financing, particularly for inputs such as medicines, textbooks, school supplies and teacher training, and therefore programs are not sustainable in the medium term as donor resources decline. Finally, expenditure levels in the social sector are quite low compared to similar countries.

Decentralization of public health and education services can contribute to increased effectiveness and efficiency of programs. Decision-making would be closer to the beneficiaries, and therefore it can be expected that resource allocation and monitoring would be improved. Equally important, decentralization would permit greater citizen participation in the design, implementation and monitoring of programs which affect them importantly and on a daily basis.

Measures to increase efficiency should be accompanied by higher levels of financing. Undoubtedly, El Salvador needs to spend more on social programs, but this will be more difficult with the loss in financing from the USG. Further improvements in tax administration can result in major increases in fiscal revenue, by reducing tax evasion which is presently pervasive.

The agricultural sector faces many restrictions. Cooperatives, key institutions in the agricultural sector, are severely constrained by antiquated and paternalistic legislation which does not permit them to compete with others in the private sector.

Electricity is provided by a highly inefficient state-owned institution (CEL). Rapid economic growth in the future would be constrained unless electricity services expand rapidly. Privatization would permit the expansion of those services without increasing public indebtedness, and the proceeds of the sales could be used to increase investment in human capital to achieve the goal of universal, high-quality basic health and primary education services for all Salvadorans.

<u>The greatest moral imperative in El Salvador is to decrease poverty, which has been estimated to affect about half of the population</u>. The 1994 ESF Program will support policy reforms designed to increase the assets of the poor, principally their human capital, and to accelerate economic growth. Of particular importance, the proposed program will support a new GOES administration which will take office on June 1, 1994. The timing of the proposed program has been set to maximize its impact during the transition period and over the first months that the new GOES administration is in office.

The measures supported by the program are summarized in the matrix presented below.

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
1. SOCIAL SECTOR			
Decentralization	Increase the level of citizen participation in decisions which affect them directly.	Approve a national strategy for decentralization and municipal development. Prepare an action plan for the implementation of the strategy.	Satisfactory progress in the implementation of the action plan.
		Prepare a decentralization strategy for health and education. Prepare an action plan to decentralize health and education.	Progress in the implementation of the action plan. Establish 1,100 new EDUCO sections. Initiate a pilot program to contract NGOs to provide the Minimum Health Package in priority zones. (Other decentralized actions to be determined.)

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
Increase Effectiveness and Efficiency of the Ministries of Health and Education	Provide greater coverage in health and family planning, allowing a greater role for health promoters and midwives.	Make the necessary administrative reforms to allow a greater role for health promoters and midwives. Design and initiate a training plan towards this end.	Finalize the training plan for the health promoters and midwives that will allow them to assume a greater role in the provision of health services.
	Improve the teacher hiring process and give greater incentives for enhanced teacher performance.	Submit to the Legislative Assembly reforms to the Salary Law for Teachers to give incentives for teachers to specialize in a given level and to teach in remote areas.	Good-faith effort for the approval of the reforms to the Salary Law for Teachers.

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
Strengthening Social Sector Finances	Increase municipal revenues to make operational the decentralization strategy.	Submit to the Legislative Assembly a new law to increase the financial autonomy of municipalities.	Good-faith effort to obtain approval of this law. Increase transfers from the Central Government to the municipalities to ___ million colones (% of the budget).
	Cost recovery in health facilities to provide funds for primary care.	Implement the cost recovery program in xxx health facilities.	Expand the cost recovery program to xxx additional health facilities.
	Improve the process of allocation of resources through a better budgeting of the Ministries of Health and Education.	Design a new budget format for the Ministries of Health and Education based on services programmed and not on historical allocations. Prepare the 1995 budget based on this format.	Submit to the Legislative Assembly the Health and Education Budget prepared on the basis of the new format.

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
Strengthening of the Social Sector Finance (Cont)	Increase resources available for health and education.	Increase the budgets for the Ministries of Health and Education with respect to GDP, in the 1995 budget (amount to be determined). Increase budget allocation for selected programs in health and education.	
	Increase fiscal revenues.	Implement measures to improve tax and customs administration.	Implement measures to improve tax and customs administration.

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
2. AGRICULTURAL SECTOR			
Development of Agricultural Cooperativism	Modernize the legal framework governing agricultural cooperatives to increase their ability to compete with private sector firms.	Submit to the Legislative Assembly the necessary reforms for the establishment of a consistent and modern legal framework to govern the agricultural cooperatives.	Good faith effort to obtain from the Legislative Assembly approval of the reforms to these laws.
3. ELECTRICITY			
Regulatory Framework	Establish a regulatory framework favoring private investment in electricity.	Submit to the Legislative Assembly all legislation necessary to encourage greater private participation in the sector.	Good faith effort to obtain approval of the legislation.

AREA	OBJECTIVE	FIRST DISBURSEMENT	SECOND DISBURSEMENT
4. MACROECONOMIC FRAMEWORK			
	Maintain stability and avoid policy reversals.	Maintain stability and avoid policy reversals; particularly maintain a disciplined fiscal and monetary policy.	Maintain stability and avoid policy reversals.
5. LEGAL/JUDICIAL FRAMEWORK	Maintain momentum of reform process and avoid policy reversals.	Maintain momentum of reform process and avoid policy reversals.	Maintain momentum of reform process and avoid policy reversals.

II. BACKGROUND

A- Economic Performance

In 1989, the GOES initiated a comprehensive economic stabilization and structural adjustment program aimed at restoring internal and external balance and reorienting the economy toward more reliance on competitive market forces. The stabilization component included improved monetary control designed to limit monetary and credit expansion to levels consistent with reduced inflation while permitting GDP growth, and fiscal austerity to reduce the Central Government's domestic financing requirements. This permitted a greater share of the net domestic credit which was available under the monetary program to finance private sector investment and production rather than public expenditures. The stabilization component also included the establishment of a flexible, market-determined exchange rate system to replace an overvalued fixed-rate regime. This improved El Salvador's export competitiveness while rationalizing import purchases.

Complementing the stabilization component was a structural adjustment program designed to reduce economic distortions and lay the basis for sustained economic growth over the medium term. Key macro and sectoral structural adjustment measures included, inter alia, external trade liberalization, revitalization and re-privatization of the financial sector, the elimination of price controls on over 200 items leaving only a few on items subject to monopolistic or oligopolistic market situations, the dismantling of government monopolies in coffee export marketing and domestic sales of basic grains, a reduction in public utility subsidies, and privatization of state-owned assets involved in commercial activities.

A near-complete overhaul of the tax system was implemented. This included the elimination of all taxes on exports, simplification of the personal and corporate income tax structure, a reduction in the top marginal income tax rate to 25 percent from 60 percent, the introduction of a value added tax, the enactment of a critical law making tax evasion a criminal offense, and improved automation, auditing and enforcement. In addition, the import duty schedule has been greatly simplified and protection of inefficient industry has been reduced while the Salvadoran economy has become more competitive. As a result of tax reforms and improved administration, tax revenues (excluding the coffee export tax) have increased to 9.4 percentage points of GDP in 1993 compared to 7.2 percent in 1989. Moreover, trade has become greatly liberalized while improvements in customs operations have enabled the GOES to maintain revenue levels.

Output: The response of the Salvadoran economy to the improved policy framework has been impressive. El Salvador is completing its fourth consecutive year of accelerating growth. Real GDP grew by 5 percent in 1993, resulting in a GDP 18 percent higher in 1993 than that recorded in 1989. In per capita terms, real GDP grew by nearly nine percent over the 1990-93 period.

Agriculture led the initial phase of El Salvador's economic recovery, responding vigorously to a major improvement in incentives to producers resulting from better exchange rate policies, the elimination of most price controls and reduced state intervention in basic grains and coffee marketing. This response was particularly noted in the increase in area planted for basic grains. Record basic grains harvests were registered in 1990 and 1992. A severe mid-year drought in 1991 prevented what would have been another record. In 1990, real GDP originating in the agricultural sector grew 7.4 percent. While there was no growth in the drought-affected year of 1991, it was followed by 9.0 and 2.8 percent real growth rates for 1992 and 1993, respectively.

In 1991, the recovery spread from agriculture to other economic sectors (manufacturing, construction, and utilities). Average real growth in these sectors accelerated from 1.1 percent in 1990 to 5.9 percent in 1991, 6.6 percent in 1992 and 9.3 percent in 1993. Reflecting major increases in public and private investment, GDP originating in the construction sector grew at an average annual rate of 10 percent over the 1991-93 period. In 1993, the real growth rates for the utilities sector was 17 percent, boosting the average annual rate for 1991-93 to 9.8 percent. Services grew at an average annual rate of 3.5 percent over the 1991-93 period.

Investment and Savings: The improved economic policies adopted since 1989, along with the consolidation of peace, have led to greater degrees of confidence in the Salvadoran economy. Gross fixed capital formation, as a percent of GDP, grew from 12.8 percent in 1988 to 16.3 percent in 1993. Private investment jumped from 9.5 percentage points of GDP in 1988 to 12.9 percent over the same period reflecting a 10.8 percent average annual real rate of growth.

Financing for this increase in investment came primarily from national savings which, as a percent of GDP, more than doubled from 5.2 percent in 1990 to 12 percent in 1993. A major component of national savings, family remittances, grew from 6.4 percent to 10.8 percent of GDP over that same period. Gross domestic savings, which excludes remittances and other factor service inflows, rose from 0.7 percent to 1.8 percent of GDP during the same period. Contributing to greater rates of savings were improved financial intermediation through the revitalization of the financial sector, resulting in greater confidence in the banking system, and gradual liberalization of deposit rates giving savers positive real returns. El Salvador still relies on substantial foreign savings to finance investment. Foreign savings (measured as the current account deficit in the balance of payments -- including remittances but excluding official transfers) was equivalent in 1993 to 4.2 percent of GDP. Nonetheless, this was less than the 6.7 percent figure recorded in 1990.

Prices: Inflation has been essentially brought under control. The disciplined monetary policies of 1990 and 1991 lowered annual (point-to-point) inflation rates at the consumer level to 19.3 percent in 1990 and 9.8 percent in 1991, lower than the 23.5 percent inflation during 1989 and the 25 percent average over the 1985-88 period. In 1992, the rate of price increases doubled to 20 percent. This was due to temporary lapses in fiscal/monetary discipline, the introduction of the 10 percent value added tax, and major adjustments in public utility rates in September 1992. The rapid monetary expansion occurred primarily because of the need for the Central Government to spend on, and the Central Bank to finance, GOES commitments under the January 16, 1992 Chapultepec Peace Accords. Restoration of fiscal/monetary restraint near the end of 1992 and throughout 1993 contributed to a reduction of the inflation rate for 1993 to 12 percent, meeting the GOES's 1993 Economic Program target for 1993. An 8-10 percent inflation rate is programmed for 1994, and is feasible if fiscal and monetary discipline are maintained.

Fiscal Accounts: Overall fiscal performance in recent years has been encouraging. The combination of marked improvement in revenue collections with generally successful efforts to restrain expenditures has resulted in a drop in the overall deficit of the consolidated nonfinancial public sector (CNFPS), excluding grants, from 5.8 percentage points of GDP in 1989 to 3.9 percent in 1993.

The deficit dropped sharply in 1990 to 2.5 percent of GDP. While increases in revenues and a small drop in current expenditures contributed to the lower deficit, the main factor was a major contraction in public investment from 4 percent of GDP in 1989 to 2.4 percent in 1990. This drop reflected a number of factors including the November 1989 FMLN offensive which paralyzed the capital city and implementation delays associated with the review and redesign of several investment projects by the new Cristiani Administration which took office in June 1989.

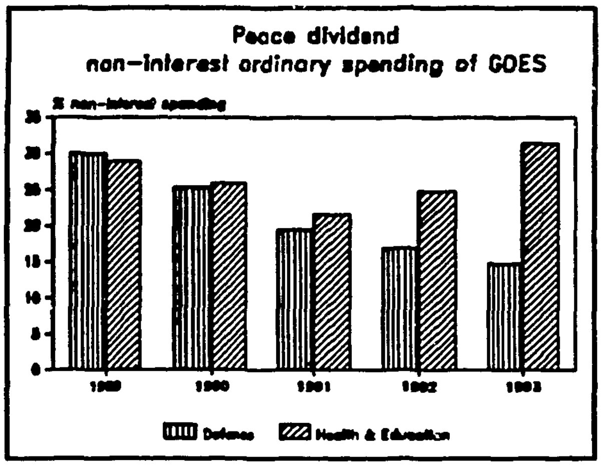
In 1991, interest payments more than doubled due to a public sector debt consolidation exercise in late 1990, and transfers to the energy parastatal surged because of higher operating losses due to poor pricing policies, the use of more expensive thermal generation to replace cheaper hydroelectric power whose output dropped due to a severe drought, and the purchase of much more costly electricity from Guatemala. These factors more than offset further revenue gains and continued austerity on other current public expenditures resulting in a CNFPS deficit of 4.4 percent of GDP.

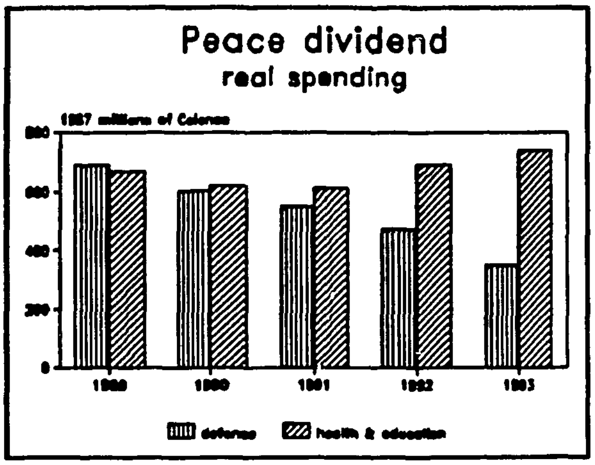
The fiscal balance deteriorated further in 1992 primarily due to a major increase in expenditures required by the implementation of the January 16, 1992 Chapultepec Peace Accords. Additional fiscal slippage occurred as the GOES delayed both introduction of the value added tax (VAT) and public utility subsidy cuts. Moreover, net lending to the private sector (to cushion the blow of falling international prices on coffee producers) added almost one full percentage point of GDP to total expenditures for the year. Therefore, notwithstanding modest but steady improvement in tax collections, and continuing fiscal austerity on non peace accord expenditures, the overall CNFPS deficit, excluding grants jumped to 5.9 percent of GDP, the highest since 1983.

Substantial improvement in fiscal performance was noted in 1993. Benefitting from the full year effect of the new VAT which replaced an outdated and failing turnover tax, as well as tighter tax enforcement and improvements in administration, tax collections rose to 9.4 percentage points of GDP, well above the 8.8 percent recorded in 1992 and nearly two percentage points higher than the 7.6 percent figure for 1989. Current expenditures, although somewhat higher than originally programmed, held steady at 12.2 percent of GDP resulting in a positive 0.4 percent of GDP public sector savings (after grants). Reflecting slower than programmed implementation of public investment projects, capital expenditures dropped noticeably to 4.5 percent of GDP compared to 5.2 percent in 1992. Stronger tax performance, lower investment expenditures, and a sharp decline in net lending brought down the 1993 CNFPS deficit, excluding grants, to 3.9 percent of GDP, two full percentage points lower than the deficit for the year before.

Financing of the CNFPS deficit in 1993 came almost entirely from official transfers (2.0 percent of GDP) and net external borrowing (1.8 percent of GDP). Domestic financing of the deficit dropped to negligible levels from 0.6 percent of GDP in 1992 and 2.6 percent of GDP in 1989.

Peace Dividend: In 1989, the first year of the current administration, defense spending made up 30 percent of non-interest ordinary spending of the GOES. This was about ¢700 million, in 1987 Colones. At the same time about the same proportion of the budget and the same amount of money was devoted to education and health (including social assistance). Since 1989 the amounts and budget shares devoted to defense have been declining. Indeed, between 1989 and 1993 defense spending has declined from 30 percent of non-interest ordinary budget to less than 15 percent. In real terms the decline in defense spending has been almost as drastic, declining by about 40 percent.





It was not until 1991 that education and health spending started to rise, i.e., that there began to be a substantial "peace dividend" in terms of rising social spending. For instance, education and health spending claimed approximately 22 percent of non-interest spending in 1991, but this rose to over 30 percent by 1993. This translates into a real increase of about one-sixth during the same period.

The 1994 budget holds defense spending to last year's level in nominal terms. This translates into a decline in share of non-interest spending to about 12 percent and represents a real decline of about 8 percent. Meanwhile, health and education spending are planned to maintain their share in non-interest spending, which translates into a real increase of about 15 percent.

Although the GOES has a long way to go to cover the dire social needs of its population, especially its poor, it is certain that without the peace the country is now enjoying and its budgetary "peace dividend" this progress in social spending could not have come about.

Money and Credit: Over the last four years, the GOES has successfully managed a generally austere monetary program. With the exception of 1992, when net domestic credit growth exceeded 30 percent, credit expansion has been held in check. In 1993, overall net domestic credit growth slowed to 18 percent. The growth rate of net domestic credit to the public sector dropped to 1.2 percent in 1993 from 15.3 percent in 1992 and an average of 33 percent for 1990-1991. This enabled more credit to be made available for private investment and production. In 1993, net domestic credit to the private sector registered 17 percent growth and accounted for 83 percent of overall net domestic credit expansion for the year. Growth in the basic money supply (M1) slowed to 17.5 percent in 1993 a significant drop from the 31.0 percent growth in 1992. Also, the broad money supply (M2) grew 26.4 percent in 1993 after expanding 33.0 percent the year before.

Interest rate liberalization over the past two years has contributed to a significant change in the composition of the monetary aggregates. The basic money component (M1), consisting of currency in circulation and sight deposits, increased from 8.6 percent of GDP in 1991 to 9.9 percent in 1992 and then declined to 9.6 percent in 1993. The quasi-money component (M2 less M1), consisting of savings and time deposits, showed a marked expansion from 16.7 percent of GDP in 1991 to 19.8 percent in 1993.

Balance of payments: El Salvador's exports, which had more than halved from $1,133 million in 1979, the country's record year for export revenue, to $498 million in 1989, jumped 17 percent in 1990 to $582 million. However, in 1991-92 export growth stagnated, primarily due to sharply declining international terms of trade, mainly because of lower coffee prices. The $598 million export figure for 1992 was only 53 percent of the 1979 figure. In real terms (adjusted by the US GDP deflator), 1992 exports were only 29 percent of 1979 exports. In 1993, exports rose to $723 million reflecting both greater volumes and improved prices for coffee as well as an 18 percent increase in nontraditional exports. Drawback exports, considered as services and therefore not included in the merchandise export totals, grew over 350 percent from $15 million (net value added basis) in 1989 to $68 million in 1993.

Notwithstanding the strong export growth achieved in 1990 and 1993, a major surge in imports has widened El Salvador's merchandise trade deficit to a sizable $1.2 billion or 16 percent of GDP. Reflecting stronger economic growth and El Salvador's more open trading regime, merchandise imports nearly doubled (in current dollar terms) from just over $1.0 billion in 1988 to $1.9 billion in 1993. El Salvador's imports from the United States more than doubled from $377 million to $885 million over the same period.

El Salvador has had little trouble financing its huge trade deficit in recent years. Continuing high levels of official transfers, along with increased family remittances, private capital inflows and official external borrowing, have enabled El Salvador to improve its net international reserve position to $650 million at the end of 1993. This is equivalent to over four months of imports of goods and services and is almost $400 million higher than in 1989.

Since the beginning of the reforms in 1989, the nominal colon/U.S. dollar exchange rate has registered a 43 percent cumulative depreciation. However, in real effective terms, the exchange rate, after a noted 20 percent depreciation during 1990, has appreciated by 18 percent since January 1991. This has caused concern regarding El Salvador's international competitiveness.

B- Social Development

In tandem with its economic reform program, the GOES in 1989 initiated a program to reduce poverty. The program was based on a three-part strategy: (1) increase economic growth in order to provide greater opportunity for productive employment, (2) improve the delivery of education and health services to enhance the ability of poor people to take advantage of the new opportunities made available by an expanding economy, and (3) provide a social safety net for those not able to improve their income generating capabilities.

1. Economic Adjustment and Growth

As described in Section A above, the first component of the GOES poverty alleviation strategy has been highly successful. The economic adjustment process in El Salvador over the last four years has created a macroeconomic environment with better incentives and support for lower-income groups to become more productive, and therefore has increased their incomes. Four consecutive years of accelerating economic growth have increased employment by as much as 120,000 jobs, reducing the open unemployment rate from 10 percent in 1990 to below 8 percent in 1991 and 1992.

This growth has also contributed to a reduction in poverty rates and improvements in other social indicators. The proportion of urban households reporting incomes below that required to purchase a basic basket of goods and services and therefore considered to be living in relative poverty declined from 55.5 percent in 1989 to 53.7 percent in 1992. However, regarding those living in absolute poverty, i.e., those households where the combined income of all members is less than that required to buy a basic food basket, there has been little change over the last three years, with the proportion holding about steady at 23 percent.

Other social indicators where recent improvement has been noted include urban homes with piped water -- up to 65 percent in 1992 from 58 percent in 1989, urban homes with indoor toilets -- up to 53 percent in 1992 compared to 48 percent in 1989, and urban homes with electricity -- up to 89 percent in 1992 from 84 percent in 1989.

2. Education and Health Services

The second component of the GOES poverty alleviation strategy includes programs and activities to improve the educational status and health conditions of the poor and hence their capacity to respond to the increased opportunities for productive employment.

Traditionally, the main factors that determined the quality of education services available to citizens have been socioeconomic status and residence, i.e., whether it was urban or rural. The Ministry of Education (MOE) has been addressing both factors through a variety of programs, using ordinary budget resources and international financing. First, several training programs (CAPS, SABE) have specifically addressed problems faced by low-income students by providing special training for their teachers. Other programs, like EDUCO, address problems like access and community involvement, especially those faced in low-income rural areas, where SABE has provided critical inputs such as textbooks and other materials. SABE is developing a new curriculum, providing textbooks and educational material. In addition, the MOE is providing additional funds into the rural areas, especially ex-conflictive zones, by an innovative program called District Funds. This program allows communities to identify their particular educational needs and secure funds to address them. Second, the urban/rural problem has been addressed by the MOE's dialogue with schools in the ex-conflictive areas formerly cut off from the official educational system. Specifically, materials are being delivered, some teachers have been trained, and the MOE is working to upgrade the skills of unofficial teachers.

As in education services, health care services have also traditionally reflected major discrepancies based on socioeconomic status and residence, with San Salvador residents having greater access to higher quality health care services than those in other urban areas, while those in rural areas have had less access to health care of lesser quantity and quality. The recent civil conflict exacerbated these differences.

The Ministry of Health (MOH), using ordinary budget resources and coordinated international assistance and in cooperation with the NGO community, has worked to reduce this gap in health care services.

* The MOH has strengthened its ability to deliver health care services by initiating the decentralization of certain functions to the Regional level, initiating the first steps of a cost recovery plan, and improving the national commodities and logistics systems (APSISA Project). The latter effort has enabled even rural health posts and centers to receive medicines and supplies on a timely basis. Increasing its own budget for medicines and supplies and using coordinated donor aid from USAID and the World Bank to purchase the same has greatly increased levels of medicines and supplies to amounts approaching adequate.

* Increasing the number of trained community health promoters nationwide and training midwives (APSISA Project), with a special focus on those in rural and ex-conflictive areas, has greatly enhanced community

awareness and use of basic health services.

* Focussing on the repair and reconstruction of the water and sanitation systems of health facilities in ex-conflictive zones (APSISA Project) has supported the work of the community health promoters by enabling them to make referrals.

* The MOH has focussed on nutritional deficiencies in 78 high-risk rural municipalities with the World Bank. Medicines, vitamin A supplements, iodized salt, child growth monitoring, nutrition education, and basic equipment for midwives have been provided to these high-risk rural locations.

* The MOH has worked well with the health NGOs to train their health promoters and support their placement in rural areas difficult for the MOH to serve.

* The MOH has increased its focus on specific health interventions that have helped reduce infant and child mortality. Specifically, through the APSISA Project, the malaria incidence has been greatly reduced and the use of ORS to treat diarrheal diseases has greatly increased; in concert with UNICEF, the immunization of children has reached record levels.

* Finally, the MOH is participating in a national health sector assessment with the ISSS, NGO community and commercial sector, soon to be completed, which will be the basis for future health sector policy and program reform.

3. Social Safety Net

A vital complement to the first two components is the implementation of social safety net programs for those poor groups which do not benefit immediately from the new opportunities resulting from the economic adjustment program, and those who are not able to improve their income-generating capabilities even with better health and education services. It is interesting to note that these social safety net programs have been implemented by decentralized entities, i.e., not through central government ministries. Indeed, these programs have depended greatly on local communities and municipal governments for much of their implementation. The main components of the GOES social safety net program include the following:

Municipalities in Action Program (MEA): The largest of these safety net activities has been implemented by the USAID-funded MEA program, in great part executed by local government.

Through this program, members of poor communities gather in open town meetings ("cabildos abiertos") to establish local investment priorities from which specific projects are chosen to be implemented. In 1991, MEA completed approximately 480 education, health, potable water projects and other employment generation activities. In 1992, over 900 new projects were added outside the National Reconstruction Program (NRP). An additional 1,297 activities were implemented in 1993, also outside the NRP. Overall, MEA activities have benefitted over 2 million low-income individuals during the economic adjustment period.

Social Investment Fund (FIS): In 1990, the GOES created the FIS to finance small-scale, labor-intensive projects to be implemented mostly by NGOs and local community groups. The projects are targeted to the poorest areas of the country and are designed to promote domestic production, including local investments in infrastructure and occupational training, as well as to help low-income groups meet their basic education, health and nutritional needs. From 1991 to 1993 the total value of FIS projects implemented reached $64 million. These projects financed vocational training for about 14,000 individuals, reforestation of about 1,000 acres, 94 nutrition projects benefitting about 25,000 children, construction of 86,000 latrines, provision of 70,000 fuel-efficient Lorena stoves, and construction and equipping of about 3,000 classrooms and 44 health centers. Through the implementation of these 3,192 projects, FIS has contributed to the creation of about 10,000 jobs. The principal source of funds for the FIS has been the IDB, with additional contributions from the European Union and several bilateral donors.

National Reconstruction Plan (NRP): With the advent of peace, the GOES initiated implementation of its $1.4 billion National Reconstruction Program (NRP) to rebuild the country, and to reintegrate formerly conflictive areas into the growing national economy. The first two years' focus was to assist the transition of ex-combatants to enjoy the benefits of the peacetime economy by providing training, employment benefits, and other benefits. The focus of the NRP as it enters 1994, is to broaden basic health and education services to the formerly conflictive areas; to continue the transfer of land to ex-combatants and small farmers; and to rehabilitate the country's war-torn infrastructure. To date, USG assistance represents more than 80 percent of the total donor contributions to the NRP.

During the NRP's first two years of operation, the following have been accomplished:

* Nearly 2,000 small-scale social and economic infrastructure projects have been initiated in the 115 municipalities in the ex-conflictive areas targeted by the USAID-funded MEA program. These projects include more than 20 schoolrooms, more

than 35 health posts, almost 150 community buildings, almost 500 rural roads, about 50 potable water projects, and 120 electricity projects.

* A program has been initiated to provide land to 22,000 ex-combatants and 25,000 poor squatters. To date, approximately 94,000 acres of land have been negotiated for and approved for sale to more than 14,000 beneficiaries. Of these, approximately 60% are FMLN ex-combatants; 20% ESAF ex-combatants; and the remainder, squatters.

* Agricultural starter packages were provided for 7,500 FMLN and 1,220 ESAF ex-combatants who chose agriculture for their livelihoods. Household furnishings were provided to 10,100 FMLN ex-combatants. About 4,200 ESAF ex-combatants have received vocational/agricultural training.

* A total of 112 NGOs are participating in the National Reconstruction Program, some of which are administering more than one type of project. Of these, six have their principal office in the United States, and the rest are local organizations.

* More than 75,000 personal identification cards (cédulas) have been provided, allowing the beneficiaries to register to vote.

* More than 35,000 people have received agricultural or microenterprise credit;

* 4,000 teachers have received training; 1,450 schools have been provided equipment and supplies, and 150 classrooms have been rehabilitated or reconstructed, extending the benefits of education to areas which were underserved in the past. Approximately 120 health facilities are being supplied regularly with medicines.

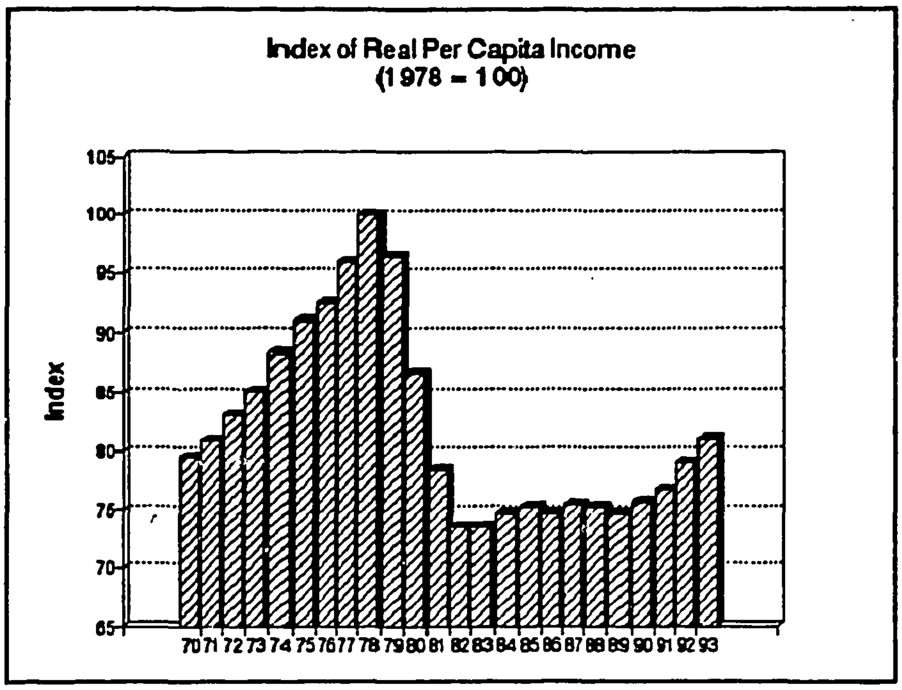
C. International Support

El Salvador's improved economic policy framework since 1989 has opened the doors to increased cooperation and support from major international lending agencies and other donors. Since 1990, three IMF stand-by arrangements supporting monetary and fiscal stability and rational exchange rate policies have been implemented by the GOES. The World Bank completed its first structural adjustment loan (SAL I) over the 1991-92 period and is now implementing its SAL II program, which supports structural and sectoral adjustment in the public sector, tax and customs reform, an improved poverty alleviation strategy, and better environmental protection policies. The Inter-American Development Bank approved an Investment Sector Loan (ISL) in November 1992 which supports policy reforms designed to improve the investment climate with measures to strengthen financial intermediation, increase savings, modernize telecommunications, and upgrade infrastructure. In early 1991, after major advances in trade liberalization, El Salvador was able to accede to the GATT. The terms under which El Salvador acceded were considered to be more open than most, making El Salvador the model for developing nations wishing to accede to GATT.

III- RATIONALE AND RELATIONSHIP TO OTHER PROGRAMS

A- Poverty Trends

GDP per capita fell by more than 25% in the period 1978 to 1982, and it remained roughly constant until 1990 when it started to rise. As a result of the poor economic performance of the late 1970s and of the 1980s, poverty increased during that period. The following graph illustrates the trend in per capita income.



While the data are not perfectly comparable, urban poverty (using the "poverty line" method, and based on the income necessary to purchase two "canastas básicas", i.e. the income per capita that would allow the purchase of two commodity baskets that would provide minimum nutritional needs for one person) increased from 50% of the total urban population in 1976 to 61% in 1988. Since then, there has been a decline in urban poverty to 54% in 1992. These data overestimate the level of poverty because they are based on the Multipurpose Household Survey (MPHS) which most analysts agree underestimates income, but the trends in the data may approximate real trends.

The World Bank has adjusted the poverty figures to compensate for the under-reporting of income. In their most recent report on this topic, El Salvador--The Challenge of Poverty Alleviation (June

22, 1993) they present the adjusted data. For 1992, urban poverty, using the poverty line method, is estimated at 43%, compared to 54% using the unadjusted MPHS data. The World Bank report estimates rural poverty at 56% and total poverty at 48%.

Although there are significant data problems, it can be concluded that poverty increased sharply in the period preceding the economic adjustment program as a result of the economic decline associated with the war, the general crisis affecting Latin America and the inappropriate economic policies followed by El Salvador. However, there has been a noticeable, albeit modest, decline in poverty rates since the adjustment program began in the late 1980s.

B- Program Rationale

Notwithstanding the recent decline in poverty rates, the poor represent roughly one half of the population of the country, and therefore the greatest moral imperative in El Salvador is to reduce poverty. Additionally, poverty reduction is a necessary condition for maintaining the peace. The reduction of poverty will require continued labor-intensive economic growth as well as programs to increase the accumulation of assets by the poor, particularly through an increase in human capital. Compensatory programs, designed to provide vulnerable groups a minimum of protection, will continue to be necessary.

As discussed in Section II, the GOES has implemented a series of economic reform measures designed to promote economic growth, and these measures have altered significantly the "rules of the game" faced by economic agents. As a result, there has been a vigorous response that is manifested in the relatively high rates of growth of the past four years. The GOES, however, has made little effort to modernize the state, and this will constitute a critical constraint to future economic growth and will make it very difficult to carry out programs designed to increase the access to assets by the poor. There are continuing physical infrastructure needs that may cause bottlenecks to future economic growth. The public sector will not be able to make the needed investments to alleviate these bottlenecks but structural changes will improve the legal and regulatory framework and encourage the private investment in the provision of these services, including, electricity, ports, telecommunications, and water.

A more modern state in El Salvador would need to spend more, on social programs, but spending needs to be more productive and better targeted. At the same time, the government continues to spend on many unproductive activities and in areas that should be left to the private sector. To achieve improved efficiency and effectiveness, a greater role in the implementation of programs should be given to the municipalities and other decentralized levels of government, to NGOs, and to the private sector. If services are provided by institutions closer to the beneficiaries, accountability and efficiency could increase, and governance would be enhanced.

C- A Participatory Policy Dialogue Process

A major change in the role of the central government is a very ambitious goal, but it is probably the only feasible way to reduce poverty significantly. The policy measures described in Section IV have been designed to reduce poverty through a modernization of the state. The USAID Mission recognizes that the implementation of these measures will require the forging of a national consensus on the need to modernize the state and therefore USAID/El Salvador is financing a series of activities designed to promote a collaborative policy dialogue.

These activities include:

1) Seminar on trade liberalization and the modern state, sponsored by ANEP where USAID/El Salvador Mission Director Charles Costello, Dr. Claudio González-Vega and Dr. Nicolás Ardito Barletta spoke on the need to modernize the state. This seminar took place in November 1993, and was attended by close to 100 legislators and private sector representatives.

2) Assistance to the GOES on the formulation of a five-year development plan. The plan was completed in early March 1994, and gives the greatest emphasis to poverty reduction and the modernization of the state.

3) Assistance to FUNDAUNGO to develop a proposal to improve the social security system. Technical assistance to FUNDAUNGO is being provided by Dr. Carmelo Mesa-Lago, a Professor at the University of Pittsburgh and a leading authority on social security issues. Assistance on social security issues has also been given to the Ministry of Planning and to the Central Bank.

4) The Mission's Public Finance Advisor recently led a group of Salvadoran officials on a tour of Customs in Mexico, a country that was able to transform a notoriously inefficient and corrupt government institution. The officials were very favorably impressed and are planning to write a document setting a strategy and plan of action for modernizing customs in El Salvador. Modernizing customs would result in increased fiscal revenue, decreased corruption and facilitate international trade.

5) Seminar on February 16, 1994, before the national elections, where the main economic and social policy research institutes (FUNDAUNGO, FUNDE, CENITEC and FUSADES) presented their proposals for the future in three main areas: macroeconomic management, including trade policy; poverty reduction strategy; and

the role of the state in society. These institutes represent a wide range of economic and social philosophy, and each have strong links to different political parties. The presentations by the different local institutes received comments from leading authorities in those fields from the U.S., Colombia and Chile. The seminar was sponsored by the Centro de Estudios Democráticos (CEDEM), an institution with the reputation of impartiality, and it received support from the International Center for Economic Growth. The conclusions of the seminar will be published by April, and this is expected to contribute to a more informed economic and social policy dialogue during the political transition period.

The results of this seminar are quite relevant to determine the feasibility of the proposed 1994 ESF Program. There was general agreement that poverty was the key issue facing El Salvador, and that the social sectors had been neglected and therefore the next administration had to increase resources to those sectors sharply. There was also consensus that the delivery mechanisms for social services were grossly inefficient and centralized, and that decentralization and the modernization of the state could contribute to efficiency and to greater citizen participation. On decentralization, some concern was expressed that a large number of the municipalities in El Salvador, because of their small size, may be unable to manage programs efficiently. All institutes felt that privatization was necessary but that adequate regulatory frameworks must be established when monopolies exist, and the privatization process has to be more transparent than in the past. There was total agreement that the greatest emphasis on the fiscal side must be to improve tax administration to reduce evasion. On commercial policy, some institutes and candidates seemed to favor a return to protectionism to assure self-sufficiency in food production, and one institute did not seem to recognize that small, open economies should strive to avoid fiscal deficits. In summary, there was a great deal of consensus on the need to emphasize the social sectors and to modernize the state, but there was less consensus on the need to maintain fiscal discipline and an open trading regime.

6) For May, 1994, USAID will finance a seminar on "Decentralized/Private Solutions to Public Problems". This seminar will explore ways in which infrastructure, telecommunications, education, health and other services can be provided more efficiently by decentralized public institutions, NGOs and the private sector. Papers for the seminar will be prepared by Salvadorans, comments will be provided by international experts, and the proceedings will be published.

7) A reduction of poverty will require more and better targeted government spending. A study of tax policy and administration is being undertaken by a foreign consultant assisted by a professor from the Universidad Centroamericana José Simeón Cañas (UCA). Another study on government spending is being

undertaken by another UCA professor jointly with USAID/El Salvador's Public Finance Advisor. We are discussing with UCA the possibility that they sponsor a seminar on public finance in mid-1994. These studies will provide an analytical framework for analyzing the fiscal implications of poverty alleviation programs.

8) A study on fiscal federalism will be completed in April 1994. Different options for financing local governments will be analyzed, and this will constitute a critical element of the decentralization strategy. Specifically, the fiscal federalism study will analyze the viability of a land or real estate tax that would be collected at the municipal level, as well as a system of general and specific grants that would be used to equalize access to basic services among jurisdictions with different resource bases.

Additionally, major studies of the education and health sector have been financed by USAID, with the latter also receiving support from the Pan American Health Organization/World Health Organization (PAHO/WHO), the World Bank and the International Development Bank (IDB). These are described in the next section of the Concept Paper.

These seminars are taking place during the pre-electoral period and during the political transition. It is expected that the key policy measures supported by the ESF program will have been the subject of a broad national dialogue by the time that the new administration takes office in El Salvador. We believe that this approach to the policy dialogue, with greater participation by groups representing a wide range of philosophies about economic and social policy, would be conducive to the design of better economic and social policies, and would contribute to improved governance. Moreover, replacing the conventional top-down approach used by most donors with one which relies heavily on Salvadorans to carry out most of the research, will contribute to greater local "ownership" of policy analysis and recommended reforms which, in turn, will contribute to greater policy stability.

D- Relationship to USAID Technical Assistance Programs

The proposed program complements and reinforces several technical assistance and other activities supporting the Mission's policy dialogue process. In 1993, the Mission initiated major sector assessments for education and health. The preliminary results of those assessments have been used to identify proposed policy reform measures geared toward achieving major improvements in coverage and quality of the health and educational service delivery systems to be supported by the FY 1994 ESF program, as well as to define potential project interventions.

The Education Sector Assessment, carried out between

September-December 1993, used an innovative and participatory methodology to open a national dialogue on education sector reform. A technical team composed of the Harvard Institute for International Development (HIID) and two Salvadoran institutions, the private, Jesuit University of Central America (UCA) and the Foundation of Entrepreneurs for Educational Development (FEPADE) worked as partners in the research and writing of the assessment. An advisory committee representing a broad spectrum of Salvadoran society worked with the team to provide continuous feedback during the assessment process. Now that the study is complete, the advisory committee's role has expanded, with Salvadoran private and governmental organizations serving as leader/promoters to disseminate the study further and recommend concrete reforms in the areas needed.

The Health Sector Assessment, initiated in September 1993 and scheduled for completion in April 1994, included several unique features: a new intensity of donor coordination; inclusion of not just the MOH, but also the Institute of Social Security, health NGOs and the commercial health sector; and, local participation and review of the assessment. Led and organized by USAID, the World Bank, PAHO and the IDB helped finance the core assessment team and several special supplementary studies. Other donors, including UNICEF and UNFPA, participated in the planning and review of the assessment. Local Salvadoran participation and review in the process were intense: Government interests including the MOH, ISSS and Ministry of Planning, NGO and commercial sector interests were represented in the initial planning and discussion stages; town meetings with local leaders, health and government officials, religious leaders, mayors, health professionals and others were held in 10 locations to review the technical reports; a Leaders Retreat with national level health and government officials and donors was held to review the initial findings and recommendations and seek consensus; an informal donors meeting in Washington, D.C. with technical staff, donor leaders and Salvadoran leaders was held to elicit donor technical review, seek consensus on the issues and recommendations, provide expressions of potential donor interest and support, and discuss the next steps. In addition, the final Health Sector Assessment Report will be presented at a National Workshop, plans will be finalized on the mechanism to develop and maintain an on-going Salvadoran Health Advisory Board, and mechanisms to continue intensive donor coordination will be developed.

In addition, the Mission has initiated the Municipal Development Project which seeks to strengthen the democratic institutions at the local level and enhance the financial viability of municipal governments. The proposed FY 1994 ESF program continues support initiated with earlier ESF programs for decentralization measures including measures to permit local governments to obtain adequate funding.

The program will support a number of actions that will increase the efficiency of the education system. It complements and reinforces directly the SABE project.

Another important area where the proposed program complements Mission TA is public finance. The Mission has mounted a major effort to assist the Ministry of Finance in the modernization of the country's tax system. Indeed, impressive gains have been achieved to date in improving the efficiency, effectiveness and equity of the tax regime. Still, important policy decisions are required for further progress needed to raise revenues to levels enabling the GOES to finance important social investment programs on a sustainable basis and ensuring that those able to pay taxes do contribute their fair share. The proposed ESF program will support fiscal measures aimed at such improvements, and thereby maximize the impact of Mission-funded technical assistance.

Poverty is particularly a rural problem in El Salvador. Programs to enhance the human capital of he poor will improve rural productivity and income, and will increase the benefits that will result from the planned Rural Equitable Economic Growth Project (CRECER).

E- Relationship to Programs of International Financial Institutions (IFIs)

The leverage provided the proposed FY 1994 ESF program provides an important reinforcement to that contained in the programs of other international financial institutions, particularly the International Monetary Fund (IMF), the World Bank (IBRD), and the Inter-American Development Bank (IDB). As a result of El Salvador's improved economic and social policies and democratic reforms, these institutions have commenced major policy-based lending programs in El Salvador in recent years. In addition to continued support for essential economic reforms, all three organizations have been placing increased attention in their programs on social development performance. Key areas where the proposed FY 1994 ESF program reinforces measures supported by the IFIs include encouraging the GOES to provide greater budgetary resources to social sectors; decentralization, expanded coverage and improved quality of social services; further progress toward a more equitable and efficient tax system; public sector accountability and anti-corruption measures; actions to improve agricultural productivity and hence the incomes of the rural poor, and steps toward relieving major constraints to sustainable growth in the electricity sector. Past experience has shown that the additional leverage provided by the Mission's ESF programs can be decisive in achieving the needed policy reforms. This is especially important for those measures of particular interest and importance to the USG.

F- Relationship to Mission Strategy

The 1994 ESF Program and the series of seminars on Modernization of the State support directly four of the five Mission Strategic Objectives. The measures are designed to increase broadly-based economic growth; to improve the health and education status of Salvadorans, with an emphasis on the status of the poorest Salvadorans; to increase the control of ordinary citizens over their lives, thus improving governance and enhancing freedom and democracy; and to reduce poverty, therefore contributing to the transition from war to peace. The 1994 ESF Program will initiate policy reforms that will be supported by planned projects in the agricultural and social sectors.

IV- PROGRAM DESCRIPTION

A- Program Design Considerations

A poverty reduction strategy must be based on two equally important elements. The first element is to promote the productive use of the poor's most important asset, i.e. labor. It calls for policies to encourage labor intensive economic growth. The second, and equally important, is to assure the provision of basic social services to the poor, which in its turn, will raise the productiveness of the poor and hence raise their earning power. Primary health care, family planning, nutrition and basic education are especially important, and should be available to all Salvadorans with an adequate level of quality.

The two elements are mutually reinforcing; one without the other is not sufficient. Additionally, certain vulnerable groups, such as the sick, the old and those who live in regions where the natural endowment is extremely deficient, will continue to suffer deprivation even if the two basic elements of the strategy are followed. Thus, a program of well targeted transfer and safety nets is necessary, particularly in a country such as El Salvador where there are pockets of extreme poverty in areas where the resource endowment may not permit even marginal increases in income.

The Modernization of the State Program is designed to support policies to promote economic growth as well as policies to increase the human capital of the poor. Over the past four years the GOES has implemented a comprehensive economic reform program designed to increase economic growth. The main economic issues are to avoid policy reversals, and to eliminate some remaining constraints, particularly on electricity and telecommunications. Therefore, the Modernization of the State Program will give greater emphasis to the second part of the poverty reduction strategy, i.e. to measures designed to increase the human capital of the poor, an area where there has been inadequate progress during the past five years.

B- Program Purpose

The program goal is to reduce poverty. The program will support key policy measures that will increase the effectiveness and efficiency of institutions delivering social services and which will provide incentives for economic growth. The measures are designed to give a greater role in the provision of services to decentralized institutions such as the municipalities, non-governmental institutions (NGOs) and the private sector. We believe that the decentralization of government activities has two dimensions, one economic and one democratic, and they are both equally important. From the economic point of view, it can be expected that decentralization of government programs and empowerment of individuals should improve the allocation of resources, as the beneficiaries of those programs have much greater knowledge of their needs than civil servants sitting in offices in San Salvador. Additionally, there is greater knowledge at the local level of the quality of programs, and therefore monitoring would be based on better information. From the democratic point of view, allowing individuals to participate in making decisions which affect them in important ways and on a daily basis increases participation in the political process, and promotes democracy in its purest sense.

C. The Proposed Program

The proposed program will support policy reforms in five areas: social sectors; agricultural sector; electricity; macroeconomics; and legal/judicial framework. The emphasis of the program will be on measures designed to promote decentralization and private solutions to public problems, to increase equality and participation by all Salvadorans, and to enhance the transparency of government operations. These measures are expected to result in a modern state, more efficient and effective, and what is equally or more important, more responsive and accountable to its citizens.

1. Social Sectors

Social indicators in El Salvador are among the worst in Latin America. Infant mortality per 1,000 is 45, and the adult literary rate is 76% for males and 70% for females. This low level of social development is the result of restricted access to social services by the poor, who are mostly in the rural areas of the country.

High mortality rates reflect the inadequate coverage of services - only 32% of pregnant women and only 29% of children under two years of age have access to some health service. About 50% of children under five years of age suffer from malnutrition, and malnutrition is higher in the rural areas. The most important cause of death of children under one year of age is diarrhea, the result of lack of access to potable water and lack of knowledge about hygienic practices.

The state of education is equally bad, and is characterized by inadequate coverage of primary education, and high rates of repetition and dropout. In 1992, 75% of children did not have access to pre-school, 24% of children between 7 and 12 years of age and more than four-fifths of children between 16 and 18 years of age were not attending school. Besides the problem of lack of access, which has a very negative effect on social equity, there is a severe problem with the quality of education: children in all grades are receiving low quality education and are leaving school poorly prepared for productive employment. The purpose of the proposed measures is to increase the effectiveness and efficiency of programs and thus reduce the child mortality rate and increase literacy.

The most important problems facing the social sectors are:

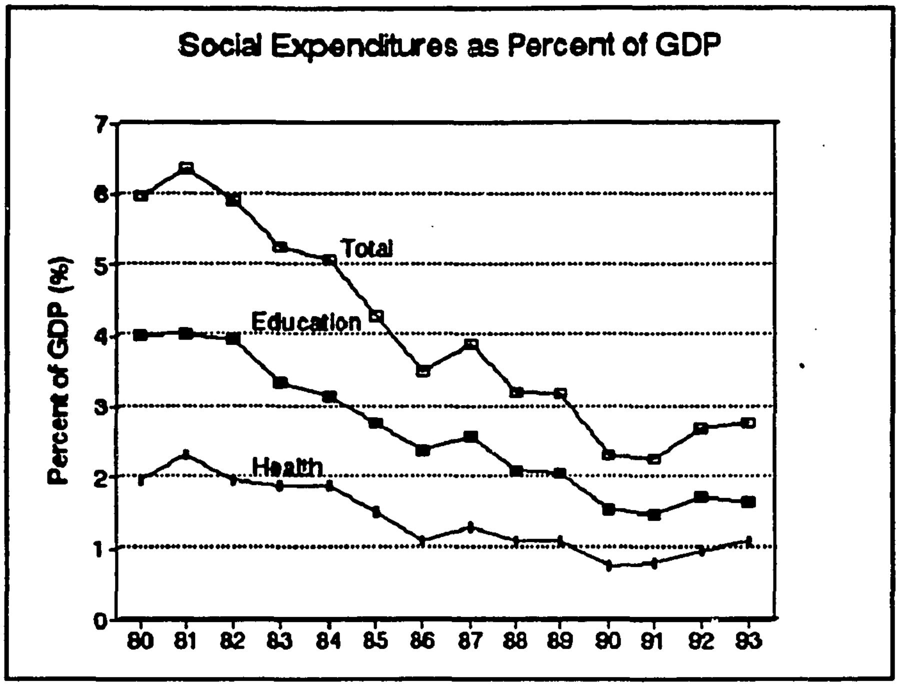
a. A high degree of centralization of the Ministries of Health and Education, which does not allow for citizen participation in decisions about issues which affect them importantly.

b. A low level of internal efficiency of public institutions in health and education, which is manifested, for example, in high repetition rates.

c. A system of personnel management which gives very little incentive to improved performance by teachers and health workers. For example, teachers in rural areas are absent up to 40 percent of the time.

d. Too much reliance on foreign financing for inputs such as medicines, books, school materials and teacher training, essential inputs for permitting a minimum level of quality. Therefore, as foreign financing is reduced, the sustainability of on-going problems will be jeopardized unless the efficiency of programs is improved.

e. Ordinary budget resources for the health and education sector deteriorated severely in the 1980's although that declining trend has been arrested beginning in 1991. (See graph below). Health and education expenditures are very low in comparison to other countries, and unless these expenditures are increased sharply, it will be impossible to improve social equity or compete in the global economy.



f. Low tax effort. Notwithstanding recent improvements in tax policy and administration discussed in Section II, above, El Salvador's tax collections are relatively low by world standards and well below levels required to finance major improvements in human resources and an adequate social safety net. Extremely high marginal tax rates have been lowered to reasonable levels. Moreover, USAID-, IMF-, and IDB-funded technical assistance programs have equipped with Ministry of Finance with a state-of-the-art tax information system and enhanced administrative capabilities. This, and recently passed legislation making tax offenses criminal acts, greatly enhances the GOES ability to pursue delinquent taxpayers. To date, however, the GOES has not made full use of these tools. Indeed, there is evidence that, after a year of relatively good compliance, value-added tax evasion is now on the rise. Unless real efforts are made to enforce the tax code, overall revenue yields are likely to decline, and the tax reform efforts the GOES has made, which have been supported with considerable donor assistance, will have gone for nought. The GOES must follow through with its tax reform program and quickly demonstrate a solid commitment to tough tax law enforcement. Current estimates suggest that the tax to GDP ratio could be raised from 3-4 percentage points through improved enforcement alone, i.e., without increases in tax rates. If the GOES fails to make a major effort to reduce tax evasion and fraud, the sustainability of education, health and other social investment activities will be jeopardized.

Proposed measures are:

a. Develop a decentralization strategy for the health and education sectors, prepare an action plan and begin implementation of decentralized interventions. These decentralized interventions could include increasing the power of the administrative board of SILOS, providing government payments to NGO's or private institutions on a per patient basis and expanding EDUCO. Additionally, some health and education services could be transferred to selected municipalities.

b. Enact legislation to permit a property or land tax at the municipal level and to establish a system of specific and general grants from the central government to the municipalities.

c. Improve efficiency of the ministries of Health and Education. Measures would include administrative modifications to permit greater role of community health promoters and MOH trained midwives in the provision of health and family planning services; expanding the pilot cost recovery program; and modifying the "Salary Law for Teachers" (Ley del Escalafón Magisterial) to improve the teacher hiring process and to give greater incentives for enhanced teacher performance.

d. Increase budget resources available to the Ministries of Health and Education. Emphasis should be given to basic health and primary education, particularly in the poorest areas of the country. Quality inputs, such as textbooks, school supplies and teacher training should be allocated funds at an adequate level. Improved budgeting procedures recently developed with USAID assistance would permit improved allocation of resources within the social sectors.

e. Tax Measures. The GOES will develop and execute an action plan to further improve tax administration, tax enforcement and customs operations. Quantitative performance targets will be established and monitored.

2. Agriculture Sector

The current laws governing agricultural cooperatives are inconsistent and antiquated. They reside in different bodies of law--civil, commercial, agrarian and govern almost every aspect of cooperative life and operations. Paternalism and state control restrict the options for innovative association under the cooperative model. One law, for instance, requires that all cooperatives submit annual statements to be reviewed and approved by the Ministry of Agriculture's Office of Agricultural Associations.

Another law requires that all members of the Board of Directors of agricultural cooperatives be elected every two years. There is no provision for staggering membership and re-election is restricted. Every two years, all cooperatives begin with new Boards and without the benefit of continuity.

Another law makes it illegal for cooperatives to accumulate profits, so it is essentially impossible for a cooperative to capitalize itself. Cooperatives should be treated like other businesses and allowed to determine their management structure, membership rules, etc. They should not be exempt from taxes or tariffs without due cause.

The paternalism and excessive controls which currently bind cooperatives are constraints to using them as solutions to a variety of problems, rural and urban. During their recent visit to El Salvador, the Board of Directors of the National Cooperative Business Association (NCBA-CLUSA) identified antiquated and inappropriate laws as "..the major constraint to cooperative development in El Salvador."

The Program will support the modernization of the laws governing agricultural cooperatives to incorporate free market principles and facilitate the formation of for profit service cooperatives.

3. Electricity

To compete in the global economy, entrepreneurs and workers in El Salvador will require reliable electricity.

For the economy to grow at 5-6% per year during the next 15 years, it has been estimated that an investment of about US$1.7 billion (on a present value basis) will have to be made in the electricity sector. In the past, CEL, the state-owned power company, has not demonstrated that it can implement an investment plan of that magnitude, and therefore it is likely that economic growth will be constrained unless a greater role is given to the private sector in the electricity sector.

Electricity rates are much lower than costs. The implicit subsidies received by the users are regressive, that is, they benefit higher income households more, as the poor consume relatively less electricity. Yet these services are so poor and unreliable that they require businesses to spend large amounts on alternatives. Thus, reform of these sectors would lower costs of business, hence raising the country's competitiveness.

Research by the World Bank suggests that sustained private investment in utilities will take place only if an adequate regulatory system is in place. Only then will there be a credible commitment to a set of rules that would protect private investors against capricious administrative action and society against monopoly power.

Modern regulation of utilities, as practiced in the United Kingdom and Chile, depends less on regulatory bodies and relies more on free market competition. In electricity, for example, those two countries have liberated the markets for electricity generation, have established rules for transmission, and have instituted regulation mechanisms for electricity distribution, particularly for small consumers. A regulatory framework for El Salvador along those lines would require passage of a legislature package that may include up to three laws. Drafting of this legislation was supported by the 1993 ESF Program. The USAID Mission has coordinated closely with the World Bank in this area. Following on the legislative approval of the new regulatory framework, the next step would be the reprivatization of the electricity distribution companies, the privatization of the thermal plants owned by CEL (the state-owned electricity company) and the adjudication of at least one concession for private electricity generation by the private sector. It is expected that privatization actions will be part of a planned World Bank power sector loan.

A more modern electricity sector will contribute to sustainable economic growth, but achieving this will require a greater role for the private sector. Additionally, the funds obtained from privatization can be used to finance investment programs in the social sectors, particularly those targeted to the poor. For example, selling only one of the distribution companies (CAESS) could yield about US$35 million.

4. Macroeconomic Framework

The maintenance of an adequate macroeconomic framework is absolutely necessary to guarantee the success of the growth promoting policy measures described above. Additionally, the most immediate result of a failure of macroeconomic stability is higher rates of inflation, and inflation has its greatest negative effect on the poor, as currency constitutes a large proportion of their total assets. The condition of an adequate macroeconomic framework has been included in the 1994 Program essentially to encourage the avoidance of major policy reversals.

5. Legal/Judicial Framework

Since 1992, the USAID/El Salvador ESF Policy and Democratic Reform program has included conditionality measures related to structural, legal and policy improvements in the administration of justice. Substantial progress has been made through the combination of policy leverage provided by the ESF program and technical assistance available under the Judicial Reform I and Judicial Reform II Projects including: the drafting and presentation of numerous legal reform proposals to the Legislative Assembly, the enactment of the Public Defenders Law, increased resource allocations and salaries for prosecution, public defense and the court system, and the integration of the Special Investigative Unit into the National Civilian Police. The momentum of the reform process, now being guided by Salvadorans, must be maintained by the new administration in 1994. Good-faith efforts by the administration to support enactment of the legal reforms to the criminal and criminal procedure codes and the provision of adequate budget resources to maintain existing programs and implement the new laws such as the Family Code are essential to building citizen confidence in democratic systems and maintenance of the peace.