PN-ABQ-645

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A Report to USAID on

The Debt Situation of Land Reform Beneficiaries in El Salvador, 1990, with Policy Alternatives addressing New Tenure Forms Available to Beneficiaries and the Privatization of the Banking System

by

John Strasma[1]

June, 1990

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[1] Professor of Agricultural Economics, University of Wisconsin, Madison, Wisconsin 53706. The author prepared parts of this study, as well as some of his earlier papers on the subject, while serving as a consultant to the Ministry of Agriculture (MAG-PERA) and to USAID in El Salvador. He greatly appreciates research assistance and suggestions by the leaders and various staff members of PERA, ISTA, FINATA, the BCR and BFA, and USAID. However, the author alone is responsible for all opinions, which may or may not coincide with those of the Ministry, USAID, or the other agencies named.

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MEASURES, ACRONYMS AND ABBREVIATIONS

Exchange rate (June 1990)	US $1.00 = approximately C/ 9.00
Units of area	1 hectare = approximately 2.5 acres 1 manzana = approximately 0.6 hectares
Crop Year	May 1 to April 30
Population of El Salvador	5.0 million (1988)
Population Density	354 per square km. of agricultural land

Acronyms and Abbreviations

BCR	Banco Central de Reserva/Central Bank
BFA	Banco de Fomento Agropecuario/Agricultural Development Bank
BH	Banco Hipotecario/Mortgage Bank
FINATA	Financiera Nacional de Tierras Agrícolas/Agency that implemented Phase III (tenants) of the 1980 land reform
FFRAP	Fondo para el Financiamiento de la Reactivación de la Producción/Agricultural Debt Refinancing Program (BCR)
FUSADES	Fundación Salvadoreña para el Desarrollo Económico y Social/ Salvadoran Foundation for Economic & Social Development
GOES	Government of El Salvador (mainly the Executive Branch)
INAZUCAR	Instituto Nacional del Azucar/National Sugar Institute
INCAFE	Instituto Nacional del Cafe/National Coffee Institute
ISTA	Instituto Salvadoreño de Transformación Agraria/Agrarian Reform Institute that implemented Phase I (large farms) of the 1980 reform, creating collective units (coops)
MAG	Ministerio de Agricultura y Ganadería/Ministry of Agriculture and Livestock
NGO	Organización No-Gobernamental/Non-Government Organization
OSPA	Oficina Sectoral de Planificación Agrícola/Agricultural Sector Planning Office (of MAG)
PERA	Proyecto de Evaluación y Planificación de la Reforma Agraria/Agrarian Reform Evaluation Project, MAG (USAID-funded; part of OSPA.)
USAID	U. S. Agency for International Development

EXECUTIVE SUMMARY

This report analyzes the debt situation of the beneficiaries of El Salvador's 1980 agrarian reform, with policy recommendations, in the context of planned changes in Phase I cooperatives and in commercial banks. The GOES plans to privatize the Salvadoran commercial banks nationalized in 1980, and to facilitate this by "bonding out" the bad debts in their portfolios, starting with those of ISTA's land reform cooperatives. The GOES also plans to offer Phase I land reform beneficiaries a choice of ways to organize and own the land assigned them, from individual parcels to continuing collective arrangements. Finally, the GOES seeks to create a viable land market finance mechanism, through which campesinos can buy land from willing sellers.

The major conclusion of this study is that the ISTA cooperatives can be reorganized and their debt problems can be dealt with effectively. Secondly, a viable land market mechanism already exists in El Salvador, and could be extended to include a modest number of farm land sales to campesinos, at no cost to taxpayers.

Thirdly, once the old debts are consolidated, it is essential that future debt obligations be treated seriously by all concerned. This will end the recurrent demand for replenishment of bank and agency capital depleted by delinquency. The Report analyzes low-cost ways to do this. They can and should be implemented now, while the shock to borrowers is softened by negative real rates of interest.

1. Reorganizing ISTA Cooperatives:

When ISTA reorganizes the cooperatives, it should pay much more attention to procedure. Some coops are too large or complex, growing coffee, cane and other crops. Some include several separate farms, whose members do not know each other. These should be divided into compact units whose members know each other and can know what's going on. Then those units should decide on how they want to be organized in the future--individual parcels or enterprises with negotiable shares, or what.

Many cooperatives have idle land. They and others have more land per member than the national average of land availability per worker (six manzanas). In both cases, new members should be admitted or part of the land split off and assigned to new beneficiaries, before deciding on the future tenure of the original group. In this way, at least 10,000 more families can benefit.

Present cooperative boundaries should not be sacrosanct, nor should 50%-plus-one decide on an issue so conflictive. Straw votes could eliminate options with no support at each cooperative. Then more discussion and perhaps division of the land should get at least an 80% consensus is attained in each unit. The final vote should be secret, and written, with voting and counting observed by respected outsiders.

Also, where members vote to operate collectively, ISTA should establish that a new discussion and a new reorganization could be undertaken in the future, on petition by 50% of the members.

2. Debt Consolidation:

"Bonding Out" the overdue and refinanced debts of ISTA cooperatives with the banks is a sensible solution to several problems. The public believes land reform debts are a major cause of the banks' insolvency; actually, they are under 5% of the problem. Thus bonding out will help focus on the real problems of the banks, planning privatization. And consolidation with the land debts will help enormously in reorganizing the ISTA cooperatives.

Early in the process of discussion, ISTA should prepare a proposed division of each cooperative's debts, among the land and the installations, based on technical criteria. However, ISTA should be ready to modify it after discussion with the campesinos, who know best what each field and enterprise is worth.

In a few cases, ISTA will write down debts so the consolidated annual payment for land debt and overdue production debt won't exceed the going land rental in the area. It should also offer a discount for prepayment, as an incentive, and credit life and accidental disability insurance. New members should assume somewhat more debt per manzana than old members, reflecting the "sweat equity" of incumbents.

Once the cooperatives are reorganized, campesinos should be free to sell their parcels or shares to other campesinos without having to explain or seek permission from any functionary.

3. <u>Future Payments</u>:

ISTA and the campesino organizations need to make clear to the beneficiaries that the new debt really has to be paid. Those who cannot support themselves and make payments must sell or rent to others who can. Proposals for Guarantee Funds raise interesting problems, especially if it is thought that they will not actually be drawn upon. Chapter 6 analyzes this problem.

New mechanisms may be needed; for instance, perhaps Solidarity groups in which members undertake to cover each other's overdue payments through what I call "Peer Intervention."

To enter the debt consolidation and get a land title or share in an enterprise, each member would have to agree, in writing, that if he failed to make a payment, the group would make the payment and evict him temporarily. By renting his land to someone else, the group would get back its money, and then the original debtor could return to his parcel. (This assumes that the payment is less than the going rent.) Costs are minimal; there is no foreclosure or legal cost, and the debtor only loses his land temporarily.

4. <u>Land Bank Mechanisms</u>:

El Salvador, like other countries, needs a Land Bank or its equivalent, to enable campesinos to buy land in the market. In present stringent conditions, this can only work if sellers can be persuaded to accept a down payment and quotas at the pace that buyers can afford. There are private real estate firms that have succeeded in doing this; they advance all the legal and infrastructure costs, and handle all the sales and collection effort. They get 100% payment by setting the sale up as a "rental with option to buy," and on making the last payment, the buyer gets a registered freehold title.

This can be done without cost to the taxpayer, and we recommend that the BCR immediately require the banks to contract with such firms to sell their foreclosed farmland, in parcels, to campesinos.

Other entities, such as FINATA and the banks and NGO's, can also be viable land banks if they can arrange a match between source of the land (or of funds) and the down payments and quotas of the buyers. External funds are not an answer unless repayment is as long as the buyers pay, and unless someone covers the exchange rate risk. In order to be credible to land sellers and lenders, land banks must have a plan to ensure effective punctual collection of payments due, as do private intermediaries.

No Land Bank can be viable if it tolerates non-payment when debtors have personal crises, yet these are bound to happen. Life and accidental disability insurance should be included in each loan, with a premium added to the interest rate. Crop insurance could help, but with realistic premiums included in the cost of production. Also, NGO's can play a vital role in finding resources with which to help the truly worthy make down payments or meet crises that threaten them with loss of a parcel.

5. <u>The Agrarian Bonds and other GOES Debts</u>:

The total of bonds issued in payment for expropriated land by ISTA will come to about C/ 850 million when pending cases are settled. As of early 1990, C/ 498 million were due, in principal and interest, but only C/ 343 million were disbursed, so the arrears are C/ 155 million. However, ISTA's only urgent problem seemed to be to find C/ 9 million in cash and C/ 76 million more to cover the interest (since 1980) already due to owners whose cases are still in negotiation.

Only about C/ 274 million in bonds are now in the hands of the public. The rest are evenly divided between the banks and the GOES, which (by law) accepts them for certain taxes. Thus the money required to cover arrears to private bondholders is modest, though if the GOES got up to date with the banks this would also help the banks' solvency.

The bond arrears should be covered, but probably along with overdue payments to GOES suppliers, rather than as a priority measure. If nothing is done, all of the bonds will eventually be used to pay taxes and the GOES will therefore have redeemed them anyhow.

Chapter One

INTRODUCTION

In March 1980, a reform-minded civilian-military Junta decreed a sweeping agrarian reform in El Salvador. Some 477 properties belonging to persons thought to own more than 500 hectares of farm land were seized, and effective possession transferred to their former resident laborers and a few other farm workers from the area.[1] A few months later, another decree enabled persons renting farm parcels under 7 hectares (10 manzanas) to claim those parcels as their own property. In both cases, the former landowners were promised compensation, mostly in 6%, 20-year bonds, for inventories and for the land, at values the owners had declared for 1976 and 1977 property taxes. The beneficiaries were to repay the government, over up to 30 years.

1.1 Scope of the Reform

After nine years, there are some 27,000 beneficiaries on the land seized in Phase I (Decree 154), plus about 5,000 beneficiaries on "traditional" (Decree 842) cooperatives formed before 1980.[2] (PERA, 1990) Nearly 43,000 former tenants got land claimed under Phase III (Decree 207), and another 2,300 are on farms bought by FINATA in 1988-90 in what amounts to a belated "voluntary sale" implementation of Phase II (Decree 839). Thus the reform sector now includes some 77,000 campesinos and their families, about 462,000 persons, or about 20% of the rural labor force.

Land allocation was not equal in the two phases. Phase I beneficiaries got enough land to average 10.4 manzanas apiece, which they were to farm collectively. The ex-tenants received only the

[1] ISTA, 1990a, p. 2.

[2] PERA, 1990a, p. 4.

parcels they had been renting, 2.2 manzanas on average, which they almost all farmed individually.[3]

Over time, there was significant turnover in both main parts of the reform. The number of beneficiaries in Phase I cooperatives fell from 38,974 at the beginning (the 1980/81 farm year) to 26,260 in the 1988/89 year;[4] it has risen slightly since then. And some of the ex-tenants were turned down because their landlords were their own parents or other campesinos as poor as they.[5]

1.2 Problems with Productivity and Underutilized Land

There has been ample discussion of the impact of the reform on productivity. In the early years (1980-86), the average yields for specific crops were similar, between the reform sector and similar land in the rest of the agricultural sector.[6] More recent figures show that the reform sector exceeds the national average yields in coffee, sugarcane, cotton, corn and sorghum, but trails it in rice and beans (frijoles).[7] However, the average quality of the land transferred in

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[3] FINATA, 1990-a, p. 3. In addition, the average quality of the land assigned Phase I participants was far better than that assigned the ex-tenants. The reason was that landowners usually rented out only that land that was too hilly, eroded, or otherwise unproductive for them to farm with workers requiring supervision and cash wages. The average value of the land assigned per beneficiary was C/ 23,300 for Phase I and C/ 2,600 for the ex-tenants.

[4] ISTA, 1990, p. 2.

[5] FINATA decided administratively to reject claims of ex-tenants when the landlord himself only owned 7 hectares or less, or was a relative of the ex-tenant. In such cases, FINATA merely promised to try to find some land somewhere else for the ex-tenant. Often, the ex-tenant remained on the parcel, but still as a tenant, still paying rent. In an undetermined number of cases, probably between 2,000 and 4,000, intimidation by landowners led the ex-tenants to withdraw their claims, or deterred them from ever presenting claims. (Intimidation also affected some landowners: under the law, Phase I landowners were allowed to retain "reserves" of 100 to 150 hectares, but some chose not to do so out of fear for their personal safety,)

[6] See, for example, the first and second Checchi Reports (1982, 1983), and Strasma, 1989.

[7] PERA, 1990a, p. 6.

Phase I was better than the national average for all agricultural land. Also, some reform sector production came from individual parcels within reform land assigned to collective units.

Many beneficiaries grew impatient with corruption, administrative problems, a lack of clear incentives, and other problems typical of collective production. Gradually, many Phase I cooperatives allowed their members to farm portions of the land in individual parcels (milpas) and household plots.

As mentioned above, the amount of land per ISTA beneficiary was greater than the national average of land per rural worker, so many landless laborers were left out. Also, when members left for whatever reason, the remaining members often refused to allow others to join the cooperative. Some hired workers by the day, or even let arable land lay fallow. Thus the area farmed collectively fell gradually, from 130,722 manzanas (91,361 ha) in 1980/81 to 90,221 (63,049 ha) in 1988/89.[8] Over the same period, the area left to "natural pasture" rose from 49,882 manzanas (34,862 ha) to 72,433 manzanas (50,623 ha).[9]

Most production cooperatives were unable to get enough credit to hire themselves or others to farm all their land intensively. They were not alone; few farmers can borrow all they wish in El Salvador's economic crisis. Also, many cooperatives failed to repay loans in the past -- just like many non-reform farm operators -- so some had been cut off by their lenders, while other lenders limited credit to "sure" cash crops such as coffee and sugar.

1.3 Reforming the Reform: Tenure Security, Refinancing and Freedom

After the change of administration voted by the Salvadorans in 1989, the new regime seeks to bring about some basic structural changes in the economy. The Government seeks to privatize the commercial banks, which were nationalized in 1980, and it has offered

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[8] ISTA, 1990a, p. 1.

[9] Same source. "Pasto natural" is a euphemism for unimproved grazing land that is neither planted nor managed intensively. A more accurate English translation would be "weeds."

Phase I land reform beneficiaries the chance to change their tenure arrangements if they wish.[10] The beneficiaries will decide, after ample discussion, whether to continue "as is," or to continue to operate collectively but each member holding well-defined, negotiable property rights in the cooperative, or to divide the land into individual parcels with individual titles. Members may also vote for a mixture of parcels and a production cooperative.

Before the cooperatives can be transformed, all parties need to reach a clear understanding of the present debts, and in some cases some of the debts should be written off as uncollectible. Whatever the new tenure form, the remaining debt must be allocated among beneficiaries in ways that are recognized as fair and that make economic sense as well.

In addition, a small part of the illiquid portfolios of the state banks are loans to the reform cooperatives. The government would like to clarify and purge these loans in order to facilitate the privatization of the banks. This Report was commissioned as part of the necessary study to facilitate both the tenure changes and the bank changes.[11]

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Coming chapters analyze the debts of the reform beneficiaries (2), the proposed reorganization of ISTA cooperatives (3), the proposed treatment of beneficiary debts during that reorganization of the cooperatives (4), the proposed "bonding out" of the overdue and refinanced debts of the cooperatives at the banks (5), and the status of the government's own debt service on the bonds issued to former landowners (6). Chapter 7 analyzes options for creating a rural land market finance mechanism for campesinos, and a final chapter summarizes the findings and recommendations of this entire Report.

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[10] See ISTA, 1990c.

[11] See USAID, 1990a, for the terms of reference of this study.

Chapter Two

THE DEBT SITUATION OF PHASE ONE LAND REFORM BENEFICIARIES

Land reform beneficiaries in Phase I generally have at least three separate debts as members of ISTA cooperatives. The coops owe ISTA for the land assigned to them, and they owe money to one or more banks for production and investment loans. Many cooperatives also owe ISTA for all or part of the "initial" or "emergency" loans made in 1980 and 1981, before they had established regular bank credit for production purposes.

As for the other part of El Salvador's land reform, the ex-tenants are likely to owe FINATA for their land, and if they have been able to obtain production credit, they may owe on that to the Agricultural Development Bank (BFA). Both kinds of beneficiaries may also owe money to suppliers or private, informal moneylenders such as relatives or village merchants.

2.1 The Land Debts.

The most basic debt of Salvadoran land reform beneficiaries is the amount they are required by law to pay for the land assigned to them. Under the land reform law, beneficiaries are supposed to repay the amount the Government agreed to pay the former landowner. After an initial grace period, the balance is to be paid over "up to" 50 years, at 6% interest.[12]

The payments are not synchronized; the government was to pay some owners in just five years, and most over 20 years. The original decrees did not say how the resulting cash flow deficit was to be covered. In practice, most ISTA cooperatives are in arrears on their land debts, and the Government itself is in arrears on service of the land reform bonds (see ch. 6).

2.1.1 Adjustments

The amount of compensation paid former owners must be adjusted both upwards and downwards to reflect the farm land actually transferred to

[12] The original provisions required beneficiaries to pay over 30 years, at 9.5% interest. These terms were changed retroactively in 1966, to 6% interest and "up to" 50 years.

the beneficiaries. First, ISTA subtracts the estimated value of any part of the properties taken, that was kept by Government agencies, for everything from watershed protection to housing projects. ISTA then adds certain amounts invested by it in improvements, restocking inventories, livestock, etc.

2.1.2 Determination of the Compensation Paid Former Owners

Compensation to former owners was based on the value of inventories, plus the land at values declared by the owner for property tax purposes in 1976 and 1977. Those owners who understated the value of their property for taxes received relatively little compensation, and their former workers, now beneficiaries, thus obtained the land for a relatively low price. However, a small minority of landowners apparently over-declared land values in 1976 and 1977, probably in order to overstate their assets as collateral for bank loans. In those cases, the compensation (and hence the land debt) may exceed the actual value of the land even under the best management.[13]

Another situation may also lead to a land price that beneficiaries cannot easily repay. Some 238 parcels, almost half of the properties seized in 1980, belonged to owners who in fact did not possess more than 500 hectares (ISTA 1989). In such cases, ISTA cannot use the tax value, but must pay full market value to the owner in order to avoid a successful appeal to the courts, return of the land, and eviction of the beneficiaries -- who have been on the land for ten years. To persuade the landowner to accept payment in bonds, which trade for 55-62% of their face value, ISTA agrees to a high nominal price for the land. The last dozen or so cases, still being negotiated or being considered by ISTA's Board, are mainly such cases. In some of these instances, it would be difficult for even the most productive beneficiaries to

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[13] The only estimate of such over-declaration known to this author was made in 1983 by the present author and the then-chief of the Valuation Division at ISTA; it was that such cases were fewer than 10% of all properties. (See Strasma, 1985.) However, that would still be some 40 farms. In addition, I have heard credible allegations of improper adjustments by ISTA's board during certain periods, raising the valuation in a dozen or more cases above that justified by the property tax declaration. Even if true, inflation far outrunning the interest rate on the agrarian reform bonds has left the compensation awarded at or below the current value of the land in most cases. However, if such abuses of power were extreme, the price of a few properties may still be too high for repayment from current farm income.

repay the full compensation to which ISTA agrees, regardless of whether the land is organized collectively or in individual parcels.

2.1.3 Amount of the Land Debt of ISTA Beneficiaries

The land debt was originally to be repaid by beneficiaries at 9.5% interest, over 20 to 30 years. In 1986 President Duarte ordered the ISTA Board to adjust the land debts, at 6% interest and with payments to begin only after a grace period running from the time the land was adjudicated to the beneficiaries, rather than 3 years after the moment of intervention (early 1980). Titles issued after his order were recorded with the debt accruing 6% interest; earlier titles were to be renegotiated.

This process had been completed (as of December 3, 1989) for some 167 cooperatives.[14] Another 27 cooperatives that had received their collective land titles with debts recorded at 9.5% (or in one case, at 7%), have not yet been renegotiated and recorded with the 6% interest rate.

Cooperatives assigned to specific properties after Duarte's order were also told the amounts of their land debt calculated at 6%, while those assigned earlier (but that have not yet received their title) were to be given new figures for their land debt, recalculated at 6% instead of the original 9.5% interest. As of December 3, 1990, 78 cooperatives had been assigned land at 6%, but had not yet received titles, and 13 had neither titles nor a recalculated debt to show the impact of the reduction from 9.5%.[15]

Table 1 reflects the land debt of Phase One beneficiaries, as of December 3, 1990. ISTA indicates that it totals C/ 1.5 billion.

However, ISTA figures for land debts as published include all the interest that is going to accrue from beginning to the end of the 30-year repayment period. This is unrealistic, because it adds together money to be paid at many different dates. In any case, it is unlikely that the repayments will be made precisely as scheduled. In other financial institutions, it is customary to keep debtors advised of the balance they owe as of a given date,

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[14] Source: ISTA 1990b, p. 6.

[15] Source: ISTA 1990a, p. 6.

after all payments made, and reflecting interest accrued only to that point. (This is usually called the "pay off amount.")

ISTA beneficiaries are not told much about the present land debts, or payoff amounts, so far as we can determine. For that matter, in various

Table 1

Land Debts of Phase I Reform Beneficiaries

According to ISTA Records, Dec. 3, 1989

Status	Number of Coopera-tives	Land Debt at Assign-ment	Total Debt Including Interest over 30 years	Amount of Pay-ments made	Total Land Debt Still Owed
		----- millions of colones -----			
Titled @ 6%	167	318.1	832.0	24.3	807.7
Titled @ 7%	1	3.2	6.6	0.0	6.6
Titled @ 9.5%	26	52.8	140.2	1.1	139.1
Subtotal	194	374.0	978.7	25.4	953.3
Assigned @ 6%	78	190.0	521.1	8.4	512.7
Assigned @ 9.5%	13	15.8	43.5	0.0	43.5
Subtotal	91	205.9	564.6	8.4	556.1
In limbo*	6	0.0	0.0	0.3	0.0
Total	291	579.9	1,543.3	34.1	1,509.5

* Note: Six cooperatives were credited for payments (i.e., money was retained from the proceeds of their coffee or sugar sales) of C/ 317,682.11, even though they have never been assigned any land. These may be cases in which the courts have ordered the return of land determined to have not been affectable under Decrees 153 and 154. Clarification has been requested.

Source: ISTA, Estado de la Deuda Bancaria y Agraria de las Cooperativas de la Reforma Agraria, Fase I. San Salvador: Marzo, 1990, p. 6.

field research projects[16] individual members of the cooperatives have been reported as stating that they have no idea how much the cooperative owes for the land.

Table 2 is an attempt to estimate the approximate amount of the land debt of ISTA beneficiaries, as of March 1990. A more accurate figure would be determined taking into account the date from which each cooperative's

Table 2

Estimated Actual Agrarian Debt, Phase I, as of 1990

Concept	Assumptions	Amounts	
		C/ million	
Debt at Assignment	Assigned in 1982, on average	579.9	
Accrued Interest:	At 6%, compounded, 1982 to 1990 on Debt at Assignment	344.4	
Total as of 1990 before Credit for Payments:			924.3
Partial Payments	Assumed made in 1984, on average	33.8	
Accrued interest	At 6%, compounded, 1984 to 1990	14.2	
Total Credit for payments on account:			48.0
Net Estimated "Pay Off Amount" of the Agrarian Debt, 1990			876.3

Note: Additional payments of C/ 317,682.11 were made by 6 cooperatives that have not yet been assigned land. Their present situation is being investigated.

Source: Debts and Payments: ISTA, Estado de la Deuda Bancaria y y Agraria de las Cooperativas de la Reforma Agraria, Fase I. San Salvador: Marzo de 1990, p. 6.

Interest Estimates: By the present writer.
The value of a sum of money at compound interest may be determined as: Capital sum x $(1 + i)^n$

[16] For example, see the PERA/CLUSA case studies of 1985.

debt actually runs, and the date of any actual payments made so far. Nonetheless, the C/ 873.6 million debt estimate in Table 2 is far closer to the true current figure than the C/ 1.5 billion figure ISTA usually publishes, which is the total land debt including all interest to be paid over 30 years. If anyone came forward with C/ 900 million right now (about US $100 million at current exchange rates), that would suffice to pay off all of the ISTA agrarian debt. Thus this figure, not the C/ 1.5 billion often cited, is the correct figure for economic analysis.

There is nothing wrong with using the C/ 1.5 billion figure in discussing payment alternatives, as long as the other alternatives are also stated in money to be paid mostly in the future. For example, ISTA will renegotiate the agrarian debts with each reorganized cooperative (see next chapter), combining the land debt with overdue debts to banks, and scheduling a combined annual payment over an average of 30 years. That total debt, including interest, can validly be compared with the present stated debt for the land alone. However, we suggest that ISTA also give the members a "payoff" figure for the land debt plus other debts with interest only up to the moment of the negotiation. This will be more accurate, and will even give them a slight incentive to agree to pay in fewer than 30 years where they are able.

2.2 Production Credit.

As of December 31, 1989, bank records show that Phase One Cooperatives were using C/ 564 million (about US $80 million) in short-term production credit. Many of the production loans were made in the current year, and were not due until March 31, 1990. Other loans were already overdue, or were not overdue only because they had been rescheduled for gradual repayment over a longer term. Loans in this latter category are called "refinanced." Table 3 shows the amount of credit in use at the end of 1989, and the share of that which was neither overdue nor refinanced.

2.2.1 Agrarian Reform Loans are not the Whole Picture.

It is important to note that loans to agrarian reform cooperatives are a small part of total bank loans to Salvadoran agriculture. This is logical, since the agrarian reform only affected about 20% of all arable

Table 3

Production Credit Used by Phase I Beneficiaries, Dec. 31, 1989, by Lending Banks, and by Performance

Bank	Current	Refinanced	Overdue	Total	Current
		(millions of colones)			%
Agrícola Comercial	17.3	14.8	0.8	32.8	52.6%
Capitalizador	18.0	2.6	3.3	23.9	75.2
Comercio	5.6	7.5	4.0	27.2	57.5
Crédito Popular	14.4	10.4	0.2	25.0	57.8
Cuscatlán	30.4	11.4	5.0	46.8	65.0
Desarrollo e Inversiones	3.7	2.1	0.2	6.0	61.1
Financiero	4.2	0.0	0.0	4.2	99.8
Hipotecario	23.0	16.5	25.4	64.9	35.5
Mercantil	11.1	1.0	0.0	12.1	91.8
Salvadoreño	43.6	20.9	2.8	67.3	64.8
Fomento Agropecuario	101.1	108.6	41.5	251.2	40.2
FEDECREDITO	0.0	1.1	1.7	2.8	0.0
Totals*	282.3	196.8	84.8	564.0	50.1%

* Note: Does not include credit extended by the Coffee Institute (INCAFE), nor by non-bank lenders such as farm supply dealers.

Source: Central Bank (BCR) and Agricultural Development Bank (BFA), as reported in ISTA 1990b, p. 5, except that data for the BFA are for Jan. 31, 1990 as reported to USAID by that bank.

land.[17] Table 3 shows total agricultural lending, by bank, in June 1987 and June 1989. Even the BFA lends three times as much to non-reform farmers.[18]

[17] Phase One, or Decree 254, affected land held by owners believed to have more than 500 hectares in March 1980. Phase Three, or Decree 207, affected parcels under 10 hectares farmed by tenants in March 1980, if they applied for it and only if the landlord was a large landowner (rather than another campesino). Thus approximately 80% of all Salvadoran farm land was not expropriated. Even Phase Two, not implemented, would only have expropriated holdings over 100 hectares. After allowing for reserves that landowners could have retained, I estimate that it would only have raised the area affected to about 26% of all arable land. (See Checchi II, 1983.) Land tenure and other aspects of the non-reform majority of El Salvador's agricultural land have been surveyed recently; see PERA 1989.

[18] Some of these, of course, are the former tenants who received land under Decree 207. However, even counting them, the reform sector gets less than half of all the loans made by the BFA.

Table 4

Bank Loans to Agricultural Borrowers in El Salvador, June 1987 and 1989*

Bank	Agricultural Portfolio, 6/30/87 Total	Cooperatives	%	Agric. Portfolio, 6/30/89 Total	Cooperatives	%
	(C/ millions)*			(C/ millions)*		
Agrícola Comercial	165.0	19.6	11.8	170.8	26.8	15.7
Capitalizador	78.2	7.7	9.8	112.4	18.6	16.5
Comercio	124.0	17.6	14.2	119.2	22.5	18.9
Crédito Popular	97.6	10.1	10.3	117.4	14.3	12.2
Cuscatlán	217.9	22.7	10.4	259.4	33.8	13.0
Desarrollo e Inversiones	33.8	2.7	8.0	41.1	4.8	11.7
Financiero	8.9	1.0	11.2	13.2	2.6	19.7
Hipotecario	228.0	32.8	14.4	469.2	70.8	15.1
Mercantil	28.4	6.2	21.8	29.9	9.8	32.8
Salvadoreño	98.4	26.1	26.5	133.5	42.4	31.8
Fomento Agropecuario	567.0	160.3	28.3	808.9	142.7	17.6
Totals**	1,647.2	306.8	18.6%	2,275.0	389.1	17.1%

* Note: June 30 farm loan figures, the only data available now, are lower than Dec. 31 figures. The farm year begins May 1; many production loans are not fully disbursed until late in the calendar year. However, the understatement is likely to be similar for lending to reform cooperatives and to all other farm borrowers.

** Note: Includes production and investment loans; does not include credit extended by the National Coffee Institute (INCAFE) nor by FEDECACES, a federation of credit unions. All of the banks are in the public sector; the Banco Hipotecario and the Banco de Fomento Agropecuario were state banks in the first place, and the other nine were nationalized in 1980, as were coffee and sugar exports.

Source: Information provided by the banks, as reported in USAID, "Status of Indebtedness of Phase I Cooperatives," USAID, 1989b, p. 5.

Between June 30, 1987 and June 30, 1989, as Table 4 shows, total Salvadoran bank lending to agriculture rose from C/1,647 to C/ 2,275 million. In part, this just reflects partial devaluation and a general inflation in production costs.[19] The share of agrarian reform cooperatives in total bank loans to agriculture fell slightly, from 18.6 to 17.1%. This reflected both the cutting off of cooperatives that failed to repay, and the ending of earmarked funding for reform sector loans in a USAID project (519-0263).

2.2.2 Investment Credit.

Salvadoran banks, even though all government-owned since 1980, have been reluctant to make medium and long-term loans to agricultural borrowers. Nonetheless, from 1986 to 1989, loans for machinery and equipment, and for irrigation to grow forage for dairy cattle, were available with funding from the Interamerican Development Bank, from two USAID projects,[20] and from small Economic Development Funds at the Central Bank (BCR).

Table 5 indicates the results. The Agricultural Development Bank (BFA) made some 170 investment loans to agrarian reform cooperatives, both those assigned to it regularly and cooperatives that obtained production credit from other banks. The investment loans represented a third of the BFA's total loans to agrarian reform cooperatives. All ten commercial banks made such loans, but the BFA loaned almost half of the total as of mid-1989.

Nonetheless, according to Salvadoran economists and my own field observations, the amount of investment credit currently available to cooperatives from banks falls far short of the amount that could be economically justified. Many coops need to replant old coffee plantations, to replace worn out farm machinery and equipment, and to install irrigation for diversification as well as for protection from drought.

2.3 Refinanced Production Loans of the Past.

In spite of the apparent need, and feasibility studies suggesting that investments would be profitable, the banks have often been reluctant to extend new investment loans to reform cooperatives. The main reason is that many of the cooperatives did not repay past production loans on time. While

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[19] Note also that the June 30 reporting date understated total farm lending by about half, to both reform and non-reform farmers. The crop year had begun, but disbursements would be considerably higher by December 31.

[20] USAID Projects 519-0263 and 519-0307.

Table 5

Bank Lending to Salvadoran Agrarian Reform Cooperatives
for Current Production and for Investment,
as of June 30, 1989

Bank	Current Production	Investment	Refinancing	Total Loans	Investment to Total
	(millions of colones, 6/30/89)				
Agrícola Comercial	4.4	6.2	16.2	26.8	23.1%
Capitalizador	5.2	8.5	4.9	18.6	45.7
Comercio	4.3	5.6	12.6	22.5	24.9
Crédito Popular	3.0	1.7	9.6	14.3	11.9
Cuscatlán	8.8	10.0	15.0	33.8	29.6
Desarrollo e Inversiones	1.1	1.0	2.7	4.8	20.8
Financiero	0.4	2.2	0.0	2.6	84.6
Hipotecario	19.8	6.4	44.6	70.8	9.0
Mercantil	5.1	3.6	1.1	9.8	36.7
Salvadoreño	14.6	11.7	16.1	42.4	27.6
Fomento Agropecuario	26.8	48.8	67.1	142.7	34.2
Totals*	93.5	105.7	189.9	389.1	27.2%

* Note: Does not include credit extended by the National Coffee Institute (INCAFE) nor by FEDECACES, a federation of credit unions.

Source: Information provided by the banks, as reported in USAID, "Status of Indebtedness of Phase I Cooperatives," 1989b, pp. 6 and 8.

many of the arrears have been "cleaned up" by refinancing, the banks do not forget that these cooperatives failed to make repayment as originally agreed. Thus many of the reform cooperatives are not deemed good credit risks for longer-term investment loans. Table 5, above, shows the extent of the problem. The column headed "Refinancing" is about twice the current production lending, and one-and-a-half times investment lending.

2.3.1 Credit-worthiness of Reform Cooperatives as Seen by Lenders. Lending officers and agricultural credit chiefs at the banks were interviewed in 1989, and were asked to evaluate the agrarian reform cooperatives assigned to them as credit risks. Of the 275 cooperatives currently served by banks, only 59 were deemed really good clients. Of those, 30 received all the credit they could use, and the rest had resources of their own and were not seeking more credit than they already had. Another 105 cooperatives were judged to have some possibilities, but the bankers were not eager to expand lending to them, and a final 111 cooperatives were simply deemed not credit-worthy at all.

2.3.2 Non-reform Borrowers are Delinquent too. Of course, the agrarian reform cooperatives are not alone in their poor repayment record. Overdues are rampant among all clients of the banks. Way back in 1982, the Checchi II team noted that bank officers reported that a higher percentage of loans to reform cooperatives were performing properly, than were their loans to other farm borrowers.[21] In the time available for this study, we were not able to determine whether this was still the case.

2.3.3 ISTA's thus-far Worthless Guarantees. In theory, ISTA has guaranteed much of the bank lending to the reform cooperatives (the guarantee is 100% of investment loans and 50% of production loans). As of June 30 1989, ISTA's exposure was some C/ 381.8 million in guarantees on loans, many of which were overdue.[22] In practice, no bank has apparently ever succeeded in collecting on the ISTA guarantee.[23] In spite of this past lack of

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[21] Strasma, Gore, Nash and Rochin, Checchi II, p. 84, 1983.

[22] ISTA, 1989, p. 36.

[23] The ISTA partial guarantee on production loans thus resembles the "subsidiary and unlimited guarantee of payment" which the Government of El Salvador made for interest and principal of the agrarian reform bonds. In practice, the Central Bank pays interest and principal on the bonds only when ISTA or someone else gives the Central Bank funds for that purpose. In my interviews over the years I have yet to find a senior Government official who assumes that the stated "unlimited guarantee of payment" really means that each year's fiscal budget simply must include the funds to make interest and principal payments that fall due that year. Nor does ISTA in practice make good on its credit guarantees from its own budget, despite its promise.

The problem is not limited to agrarian reform bonds; it also applies to the bonds issued by a sewer authority and other autonomous state enterprises. Worse, from an investor's viewpoint, no interest accrues on overdues. When and if they are eventually paid, it is at the number of colones that were due on the original due date.

performance, ISTA decided to buy all the overdues and many of the more doubtful current loans made by banks to the agrarian reform cooperatives. ISTA would pay the banks with its own agrarian reform bonds. We analyze this proposal separately, in the next chapter.

2.4 <u>The Emergency, or Initial, Operating Capital Loans</u>:

In early 1980, just at the start of the farming year, the farm holdings thought to exceed 500 hectares were seized. Their workers were told that they were the new owners. Effective immediately, they were to farm the land, as a production cooperative, directed by an elected committee of their own members, assisted by an ISTA co-manager.

ISTA assumed that it would take time to establish bank credit for the fledgling cooperatives, and planting time was at hand.[24] Therefore the Agricultural Development Bank (BFA) supplied significant amounts of cash outright, which was carried to the cooperatives by the land reform functionaries in order to get farming operations started. As each cooperative established working relations with a specific bank, these early loans were transferred to that bank. Out of the original 90 million colones (then US $36 million), only 20 cooperatives repaid their initial loans in full. The others that received these initial advances, 154 cooperatives, still owe C/ 60.5 million (USAID-1990a, p. 10).[25] At a current exchange rate over C/ 7.3 per dollar in March, 1990, this is under US $8 million.

The only saving grace is that the interest coupons and bonds due for redemption may be used in full payment of various taxes due. Bonds can be used even before their maturity, at their nominal value, in payment of gift and inheritance taxes. Both the bonds and the interest coupons are freely transferable, and there is an active informal market in them. Recent quotations were about 55% bid, 62% of face asked for the bonds, and 90 to 95% of face for the interest coupons due. As of early 1990, the Government had involuntarily made good on some C/ 250 million in bonds and C/ 95 million in interest coupons through their use to pay taxes. This was almost as much as the C/ 357 million it had actually paid to bondholders with ISTA or GOES money budgeted for that purpose.

[24] The Salvadoran farm year begins May 1, as does the rainy season.

[25] Some of these have repaid some of the initial advances.

In 1982, ISTA bought those loans from the banks, paying with agrarian reform bonds which the banks could hold as investments in place of the original loans. The loans are still liabilities of the cooperatives, listed in some published tables as the BFA-ISTA Portfolio. In 1986, ISTA decided not to accrue interest on the balances due, after 1982.[26]

Some cooperatives question whether they ever received the money in the first place, or argue that the beneficiaries of 1980 are long gone and the present members did not receive the money, nor benefit from its use. In any case, this debt does not accrue interest. If it were repaid, the money would go to ISTA rather than to a bank, so it would not improve the coop's credit rating at the bank. Cooperatives thus have little incentive to pay, even if they admit that they owe the money, which many do not.

Ten years overdue, these loans are clearly uncollectible, and should be written off as such. This is essentially what the current Government proposes to do. (See Recommendations, below.)

2.5 Total Debts of ISTA Cooperatives:

Adding up all the major debts of ISTA's agrarian reform cooperatives, we find a fairly grim situation (see Table 6). Only one cooperative has actually paid off all of its debt, including the land.[27] Relatively few cooperatives have operated at a profit, and hence been able to repay their production credit, let alone make the first payments on the land debt or address the overdue initial loans.

As of December 31, 1989, C/ 281.6 million of the C/ 564.0 million in credit extended by all the banks to agrarian reform (Phase I) cooperatives was overdue or refinanced; this was 49.9% of total loans to agrarian reform cooperatives at that time. Half of the credit extended by banks to agrarian reform cooperatives was current and 35% had been refinanced; only 15% was recently overdue, and some part of this was for coffee that had been sold but the cooperative had not yet received its money.

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26 ISTA's Board Acta 12-86, dated April 4, 1986.

27 The "La Argentina" Cooperative. USAID, 1989b, p. 9.

Most banks were affected by the non-performing loans, but to different degrees, as shown in Table 6. The differences reflect in part the success of some of the banks in getting assigned only the best cooperatives, and in refusing to lend to any others assigned to them. One bank reported no delinquency at all, though it had made very few loans to agrarian reform cooperatives. (And recall that the banks lend more to non-reform farm operators than to Phase I cooperatives, and that the non-reform borrowers are hardly exemplary in performance on <u>their</u> loans.)

Table 6

Debts of Agrarian Reform Cooperatives (Phase One), by Bank, as of Dec. 31, 1989

Bank	Current	Refinanced	Overdue	Total	Delinquent
		(millions of colones)			
Agrícola Comercial	17.3	14.8	0.8	32.8	47.4%
Capitalizador	18.0	2.6	3.3	23.9	24.8
Comercio	5.6	7.5	4.0	27.2	42.5
Crédito Popular	14.4	10.4	0.2	25.0	42.2
Cuscatlán	30.4	11.4	5.0	46.8	35.0
Desarrollo e Inversiones	3.7	2.1	0.2	6.0	38.9
Financiero	4.2	0.0	0.0	4.2	0.2
Hipotecario	23.0	16.5	25.4	64.9	64.5
Mercantil	11.1	1.0	0.0	12.1	8.2
Salvadoreño	43.6	20.9	2.8	67.3	35.2
Fomento Agropecuario	101.1	108.6	41.5	251.2	59.8
FEDECREDITO	0.0	1.1	1.7	2.8	100.0
Totals*	282.3	196.8	84.8	564.0	49.9%

* Note: Does not include credit extended by the Coffee Institute (INCAFE). This table is the same as Table 2, except that the last column refers to poorly performing loans rather than the percentage that are current.

Note: Does not include initial loans not repaid, currently held by ISTA and not accruing interest.

Source: Central Bank (BCR) and Agricultural Development Bank (BFA), as reported in ISTA 1990b, p. 5, except that BFA data is for Jan. 31, 1990, and was supplied directly to USAID; all other data are for Dec. 31, 1989.

2.5.1 Agrarian Reform Cooperatives are not the Banks' Only Problem.

Recently, as part of the process of studying the relatively greater problems of the nationalized banks themselves, an outside auditing firm and the individual banks classified each borrower from A to E, with A being the most credit-worthy and D and E totally unacceptable as credit risks. The BCR then suggested that reserves be established on the basis of 10% of the Class C loans, 50% of the Class D loans, and 100% of the Class E loans.

The result, on which several independent consultants appear to agree, was that the creation of bad debt reserves sufficient to reflect the true asset value of the loan portfolios, would leave all but one bank with negative net worth. The one exception would barely be in the black.

The Government of El Salvador deems that an unacceptable step, even though the situation was built up under past administrations, and even though it arose in the middle of a civil conflict that exacerbated many economic problems.

The entire net worth of nine commercial banks, as of Nov. 30, 1989, and without making the drastic bad loan reserves recommended, was some C/ 383 million.[28] The auditors wanted to establish reserves for uncollectible loans on the order of C/ 2,000 million just for the nine commercial banks. All the loans to all the agrarian reform cooperatives of Phase I as of December 31, from those 9 commercial banks, were only c/ 248 million, and C/ 157 million of that was current.[29] Thus the debacle of the commercial banks cannot be blamed mainly, let alone solely, on the agrarian reform cooperatives. They account for under 4% of the C/ 6,300 million total loan portfolios of the commercial banks.[30]

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[28] Síntesis del Programa de Rehabilitación de la Banca en El Salvador, 14 de Diciembre de 1989, Anexo 2. Does not include the Banco Hipotecario. Two of the commercial banks subsequently merged.

[29] See Table 6. Figures are for cooperatives' debts to commercial banks, excluding the Banco Hipotecario and the Banco de Fomento Agropecuario.

[30] Síntesis, item cited, p. 5.

2.5.2 Neither foreclosure nor bankruptcy appears to be an option.

Technically, the majority of the cooperatives are insolvent. Their assets are less than their liabilities. (The land is carried at its value as assigned to the cooperative; unless payments have been made on the debt, an equal amount appears as a liability. Thus we are really comparing inventories and bank balances with bank debts.)

Despite this apparent insolvency, there is little their creditors can do. They do not have mortgage liens on the cooperatives' land, and they cannot foreclose on it, nor can they seize assets of the individual members. Unlike other businesses in trouble, the cooperatives cannot invoke the protection of the bankruptcy laws, because the State has been "too good" to them. Because ISTA has formally guaranteed repayment of 50 to 100% of their production and investment loans, the banks have insisted that the loans are "good" even if they are completely non-performing. Yet ISTA has no funds with which to make good on the guarantee, and the lending banks have no way to force ISTA to sell assets or otherwise come up with funds to make good on the guarantee. It is a frustrating situation for all concerned.

2.5.3 Other debts of Agrarian Reform Beneficiaries.

Some, and perhaps almost all, agrarian reform beneficiaries have other debts as well. In the time available it was not possible to obtain reliable figures on debts to input suppliers, nor personal debts of individual beneficiaries to moneylenders, relatives or others. In many cases, beneficiaries owe small amounts to their own cooperatives, which provide small loans as part of a general category of welfare programs for cooperative members.

Many cooperatives provide seed, fertilizer, etc. to their members on credit, for use on the milpas assigned to the members for household production. (One reason for doing so is that cooperative leaders believe that otherwise the members would steal cooperative supplies; this way, at least they pay for them at harvest time. See PERA-CLUSA, 1985.)

Also, some cooperatives have not obtained formal bank loans for production credit in recent years; they or their individual members are quite likely to have small amounts of supplier credit or personal debts that are not recorded at ISTA nor in the formal banking system. The amounts of such debts are probably much smaller than the formal debts noted here, but they may be significant to the individual debtors. Thus the figures in Tables 3 and 6 represent a lower-limit estimate of the actual debts of Phase One beneficiaries as of early 1990.

2.5.4 Debts of Abandoned Phase I Cooperatives.

There are several special cases among Phase I cooperatives that should be analyzed separately. For example, some cooperatives have been abandoned by their members. Others, although still populated, are worked in individual parcels and have no cooperative structure, even though there are still debts outstanding in the name of a former cooperative. What is to be done with the debts of the former cooperative, and how shall the land debt be allocated among the people now farming that land?

PERA, in its most recent Census, records thirty cooperatives as abandoned.[31] Only six of them had outstanding debts for past production credit. The largest debt is that of Guajoyo, a Cooperative that was assaulted in 1981 by gunmen who killed eight members of the Board. The members told me in 1982 that they believed the goal of the assassins was to destroy the cooperative as a successful example of collective operation in the Santa Ana area; if so, they succeeded. The land is worked individually and no one has attempted to lead in forming a new collective among the campesinos living there. The shock of the murders caused the failure of that year's harvests, and the debt went unpaid.

Even in this case the overdue production debt is only a fifth of the land value. As shown in Table 7, the total overdue loans for all six cooperatives are only C/ 819,101, and it would appear that the lending banks should have written them off long ago as uncollectible. A few years ago, the number of abandoned cooperatives was about the same, but the unpaid debts were somewhat larger (Strasma, 1985). It is unclear whether the PERA inventory is incomplete, or lenders did in fact write off some of the unpaid debts of abandoned cooperatives, or ISTA persuaded the members of reorganized cooperatives to assume responsibility for the unpaid debts. (In a few cases,

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31 PERA Data Bank, printout dated 3/30/90. (PERA, 1990b.)

the members may have been the members of the former cooperative, returning to the area when it was safe to do so, and paying off some of the debts.)

Table 7

Debts of Abandoned Phase I Cooperatives, El Salvador, 1989

Property	Land Value	Bank Debts Overdue
San Pablo Cazales y Sihuatepeque	C/ 872,500	C/ 100,378
Los Chorros	165,727	1,303
Santa Marta, Las Puertecitas	n.a.	140,100
Guajoyo	1,434,350	302,362
Vado Ancho	248,900	16,000
La Esperanza o Ceiba Doblada	2,420,875	235,400
Nanachepa	2,007,034	23,558
Total Overdues:		C/ 819,101

Source: PERA data bank, 30 March 1990. N.a. = Not available.

Table 7 shows only the six abandoned cooperatives that also have production loans outstanding. Including them, the value assigned all of the land in the thirty cooperatives listed currently as "abandoned" adds up to only C/ 19,540,792.[32] This is about 3% of the value ISTA placed on all land assigned to beneficiary cooperatives in Phase I of El Salvador's agrarian reform (see Table 1, above).

2.5.5 Debts of the Self-managed Cooperatives. ISTA declared 53 cooperatives to be self-managed ("autogestionaria") in mid-1989, and toward year-end declared 37 more to be the same. Table 8 classifies the first 51 of these with respect to the bank serving their credit needs and the credit classification (A to E) assigned each cooperative by its bank. (None were so poor credit risks as to be assigned to class E, but some fell into C and D.)

[32] Same; i.e., PERA Data Bank, printout dated 3/30/90.

Table 8

51 Cooperatives Declared Self-Managed, by Bank Attending Their Credit Needs and by Credit-worthiness, 1989

Bank	No. of Cooperatives Assigned, by Credit-Worthiness				
	A	B	C	D	Total
Agrícola Comercial	3				3
Capitalizador	1	1			2
Comercio	2		1		3
Crédito Popular	4				4
Cuscatlán	1		4	1	6
Desarrollo e Inversiones					0
Financiero					0
Hipotecario	3		4	1	8
Mercantil			3		3
Salvadoreño	2				2
Fomento Agropecuario	4	1	15	-	20
Totals*	20	2	27	2	51

Note: None of these cooperatives were classified "E."

Source: USAID, 1989-b.

2.6 Recommendations:

2.6.1 Write Off Most of the Initial Loans. We recommend writing off completely the initial loans to all cooperatives where there is reasonable doubt as to whether the money was actually received, or as to whether the present membership includes the people who benefitted from that initial credit. If the cooperative has claimed that it is in one of these situations, that claim should have been documented long ago in ISTA's records.

These initial or emergency loans are currently a nominal asset on ISTA's books, but most are really not collectible. ISTA's Board has the power to write them off, and should do so immediately in the two cases cited.[33] The borderline cases would be those in which 1) the loan was received but because

[33] Unless, of course, ISTA wants to agree to write these off, but in the context of negotiations over the rest of the debts of a given cooperative and as part of an overall agreement. The policy, in any case, should be to write them off.

of bad management, bad judgment or bad weather, that first year was not profitable, and 2) the loan was received, and some, but not all, of the members who received it are gone. Given the age of these loans, I would recommend that ISTA write them off as well.

2.6.2 Write off Doubtful Production Debts as Well. The only other category we would recommend writing off would require a financial sacrifice by ISTA, as guarantor of much production credit. Yet when a production loan is overdue for many years, or when there has been a nearly-complete turnover of membership since that credit was utilized, it is very difficult to persuade the present members to pay it off. Likewise, it is nearly impossible to collect if massive losses were caused by violence, as at Guajoyo. This would need to be determined on a case-by-case basis, but ISTA should long ago have made good its guarantees on the C/ 819,100 in overdue loans to cooperatives that have been abandoned. That is, ISTA would have paid the lending bank in full for loans guaranteed at 100%, and 50% of the amount where ISTA only guaranteed 50% of the loan.[34]

In the 50% case, the bank itself would have to write off the other half against its own reserves for bad debts. However, ISTA would have made good on its guarantee, and all the balance sheets would be a little closer to reality. The loans would no longer appear as assets for either ISTA or the bank, nor would they appear as liabilities of cooperatives in the reform sector. In practice, of course, the abandoned coop debt was extinguished together with all other overdue bank debts, and at 100%, not 50%.

ISTA plans to "cap" land payment at presumed rental values (see next chapter). This could eliminate the need to review the whole credit history of each cooperative with overdues or refinancings, before deciding on

[34] The payment would be in cash only if ISTA had the money; press reports state that ISTA actually paid the banks with 6% 30-year bonds that begin with a 10-year grace period before any amortization is due (Rosenthal, El Salvador News Gazette, May 21-27, 1990). However, under other provisions concerning land reform bonds, the banks may be able to convert these bonds into 12% "compensatory" bonds that the GOES promises to redeem in just 10 years. While not as good as collecting normal interest in full, this would certainly be better from the lender's viewpoint than holding a non-performing loan.

a definitive organization and land tenure arrangement. Nonetheless, as ISTA's "facilitators" work with the members and leaders of each cooperative to help them decide on future organization, they might as well clarify that history to the membership. This will help the members understand the extent to which they have an obligation to repay a share of credits earlier extended to them as a group.

2.6.3 Land Debts Need Not be Written Off. We do not recommend writing off any part of the land debt, except in the few cases in which the former owner was compensated at more than the value of the land, based on its potential production. That could be determined on a case-by-case basis; again, ISTA's plan to use land payment based on rental values achieves the same result. It eliminates the need to review the land value in cases in which the cooperative alleges that the value is too high.

In a few cases, in which the land lies in a conflictive area, it is possible that the productive potential of the land is greatly impaired (for instance, by guerrilla land mines or unexploded army munitions). In those cases, a realistic discount in presumed land rental values (given those hazards) would suffice to reduce the land debt appropriately.

Chapter Three

GOES Proposed Policy Actions Concerning Land Tenure and Farm Organization

The present administration of ISTA has announced a major program to allow Phase I beneficiaries to decide for themselves how to operate the land that has been assigned to them. They are to choose freely among various ways to hold the property rights associated with that land and the productive enterprises on the land.

3.1 Facilitators and Options.

A recent document[35] envisions working with 187 cooperatives in the first year, in which a "facilitator" from ISTA will explain the options available so that the beneficiaries can make an informed choice. These options will be:

1. Divide the land into individual parcels and individual titles.
2. Collective ownership with documented "real" rights or shares.
3. Mixed arrangements: individual parcels plus collective enterprises.
4. Collective ownership (essentially, the present model).

In practice, ISTA's top leadership states, the members of each cooperative will be able to design a custom-fit arrangement that best suits their specific situation. Effective immediately, the "co-manager" from ISTA is to be retrained to perform a "facilitator" role, and his primary task for the coming year will be to inform coop members of their choices and help them design specific choices that fit their crops, land and membership.

In the end, the plan is that the members of each cooperative (not ISTA) will decide, by vote, which model shall be adopted -- and the majority view will be binding for all members of that cooperative.

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[35] ISTA 1990c. Liberalización de las Formas de Tenencia de la Tierra en el Sector Reformado, Alternativas para su Reactivación, marzo de 1990.

3.2 Potential Alternatives and Concerns

The ISTA proposal is admirable, and far more democratic and sensible than a blunt mandatory privatization into individual parcels in every case, which is the policy that some ISTA staff had been announcing. Nonetheless, prior research in the Salvadoran countryside suggests the need for attention by ISTA leaders and the campesinos to a few basic issues:

3.2.1 Some Cooperatives are Too Large. The present dimensions of some cooperatives are much larger than is needed to achieve economies of scale for the crops they produce. The present cooperatives tend to reflect whatever mix of properties a former owner had assembled -- often the product of non-farming forces such as inheritance, land speculation, bankruptcies, divorce, or the like.

The problem is particularly serious with non-contiguous lands. When a private owner has several farms, he can shuffle machines, workers and working capital among them fairly easily. But when one cooperative tries to manage several farms, such shuffling rather easily supplies opportunities for theft or mysterious disappearance of supplies. No individual member can keep an eye on the Board members if much of their work is away from the farm where the member lives and works.

The 1985 PERA-CLUSA case studies made the problem dramatically clear. Many coop members said they would feel more like owners and less like workers on state farms, if the cooperatives were down-sized to the point that each member could really know what was going on. They also said that if the coops were smaller, they would not need hired managers or ISTA co-managers, because the whole management job would be less complex.

Membership of 50 to 100 families is probably optimal; more than that makes it necessary to go to professional full-time management and a representative governance which guarantees that the vast majority feel they are workers, not owners.[36]

There are scale economies in agriculture, in many crops, but they come largely from specialization or in processing. Processing requires much less land than growing, and in any case is often best entrusted to a service

[36] PERA-CLUSA, 1985.

cooperative, rather than kept under the same management as crop production. Specialization for most farm jobs only requires the presence of 50 or so members at most. On these criteria, many ISTA cooperatives are too large and should be divided into more manageable sizes.

3.2.2 Accommodation of Minority Preferences. The ISTA document implies that whatever the majority decides, will be the binding decision for each entire cooperative, even if the decision is by 50% plus 1 vote. That could be a recipe for disaster, internal conflict, and poor morale, according to experience in group decision-making elsewhere in rural Latin America.

The campesino organizations should be asked to help design a rule for a "qualified majority" that would ensure reasonable consensus among the members. It might be 4/5, or 2/3, or even 90%, for instance. Even the members of the majority will feel that the whole process is fairer, if there are reasonable provisions for paying compensation to unhappy minority members who resign and go away, rather than accept the majority decision.

Once this concept is combined with the possibility of dividing the land of a cooperative into two or more separate entities, then it becomes possible to imagine solutions that leave almost everyone completely happy.

If certain crops lend themselves best to individual parcels, let those members who want individual parcels have them -- and if other crops lend themselves best to group or collective production, let those members who prefer to work together, do so. Neither has to live with something they dislike, and the members of each of the new cooperatives should be able to achieve close to 100% unanimity on how to organize the land they have been assigned.

What this suggests is that ISTA and the campesino organizations state explicitly to the membership that the present borders of each cooperative could be modified, and large cooperatives could be divided, if that would help achieve a better fit for the true desires of most members.

A direct statement from ISTA leadership is necessary, because most ISTA staff and most campesino beneficiaries assume that the present cooperatives are "sacred" and that the decision unit must be the present members of each cooperative in the boundaries it happens to have now.

3.2.3 Membership Capacity. Phase I of the land reform has fallen far short of its original goal of 50,000 beneficiaries, mainly because many cooperatives have refused to admit new members in proportion to the land assigned to the cooperative. The national average of rural laborers to agricultural land is about 1 worker to 6 manzanas of land (ignoring quality). ISTA cooperatives tend to have land that is better than the national average, and yet many also have more than 10 manzanas of land per member.

As a result, many cooperatives have underutilized land and "natural pasture" that ought to be put into improved pasture or crops. There are large numbers of rural landless workers who want that underutilized land.

It is understandable that some cooperative members are reluctant to bring new people, not well known, into their social and work group. However, in many cases the solution is simple: "hive off" part of the land and use it to assign parcels to refugees, displaced persons and other landless workers. Leave the present members farming a more compact, contiguous and highly productive core, on which they enjoy the fruits of a decade of hard work.[37]

3.3 Recommendations

It is recommended that ISTA leadership consider the following:

3.3.1 Retrain ISTA Staff. Staff members in the field have not kept up with the decisions taken by ISTA leadership; they should be retrained before they are sent to tell the beneficiaries what the alternatives are.

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[37] A clear example of the feasibility of this approach is visible at Miravalle cooperative, in Sonsonate. Several hundred manzanas were simply not farmed in the crop year just ended. The former owner operated three separate farms, side by side, but each with its own cluster of worker houses and its own management. The two outlying farms are the areas with the idle land; they should be spun off to form two new cooperatives, leaving the present members on the core farm, which is quite productive. A Board member with whom we discussed beneficiary thinking on ISTA's alternatives, in late March, agreed that this would be desirable. He thought it would be acceptable to the members if ISTA made a good presentation of the capacity problem and the need to find land for the landless.

3.3.2 State that Large Cooperatives may be Divided. Make it explicit that cooperatives that are larger than is strictly necessary, may be divided. With two or more units that are more compact, all members can know each other and supervise their leaders more effectively. Explain that with simpler, smaller farms you can still have efficient production -- and you have much less need for an expensive farm manager, or for an ISTA co-manager.

ISTA facilitators should encourage the members to think early on, about whether their present boundaries are ideal. If the land has already been transferred legally to the cooperative, it could perfectly well split into two or more farms just as a private owner could. If it has been assigned by ISTA, but no title has yet been transferred, then after the campesinos voted in favor of a division, ISTA could simply issue title accordingly.

3.3.3 Provide Clear Voting Rules, Observers and Safeguards. In early public statements, ISTA has insisted appropriately that the members -- not ISTA, and also not the directiva nor the campesino organizations -- will choose which form of organization and land tenure they want. ISTA and the Campesino Organizations should write and publicize specific rules that ensure secret voting and honest counting, to guard against bullying or fraud. Outside observers, such as church leaders and educators, themselves from various "schools" of thought, would help prevent false accusations that ISTA or the Campesino Organizations had forced the campesinos to a solution they did not really want.

3.3.4 Adopt a Qualified Majority Voting Rule. In early statements, ISTA has stated or implied that a majority of 50% plus one vote, will force all members of a cooperative into one plan of organization and land tenure. This is a recipe for future conflict and a repeated demand for new elections. Better, whenever a vote of 80% or more is not achieved, the cooperative should probably go back to discussing the alternatives until a consensus is reached and then confirmed with 80% or more of the votes.

If it is simply not possible to reach that consensus, then future harmony will be furthered by dividing the Cooperative into two or more farms, with different organization and tenure plans. The members will be free to join one or the other, with the amount of land assigned each depending on how many choose one and the other. Then a secret, written ballot should confirm that a harmonious overwhelming majority support the final proposal.

ISTA's Acquisitions and Valuation Department is well-qualified to make a technically sound allocation of the land debt according to the potential income-generating ability of the two or more portions into which the present farm is divided. However, if members so petition, ISTA could spare itself a headache by inviting the cooperative to hire its own expert for the job.

3.3.5 <u>Insist that Land per Member (Capacity) must Reflect the Availability of Land and Workers</u>. The ISTA beneficiaries produce about C/ 425 per manzana, with collective holdings averaging 10 manzanas (7 hectares) per beneficiary. FINATA's beneficiaries average C/ 1,772 per manzana, on much smaller holdings (averaging 2.2 manzanas, or 1.53 ha.)[38] This suggests that agricultural production would rise if more workers become beneficiaries on the land ISTA already has, because land, the scarce factor of production, will be farmed more intensively.

This productivity gain will be even greater if those beneficiaries who are not persuaded that collective operation is in their best interest, are effectively allowed to farm in small voluntary partnerships or individually, as do most FINATA beneficiaries.

ISTA staff members have always tried to persuade cooperatives to admit new members, and the new document makes it clear that this also applies in the context of the new tenure options.

Specifically, the ISTA document suggests that according to soil quality, the appropriate agricultural area per family should be between 2 and 7 hectares (3-10 manzanas), and that a household lot (solar) should not exceed 600 square meters.[39] This is appropriate; the national average ratio of rural laborers to agricultural land is only 6 manzanas, and yet ISTA cooperatives average over 10 manzanas per member, even though the average quality of their land is also better than the national average. The present beneficiaries appear to be a sort of privileged minority within the ranks of

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[38] FINATA, 1990a.

[39] ISTA, 1990c, p. 14.

rural workers, which is certainly not the purpose of a land reform. Thus an average of 6 manzanas per member is very much in order.

When cooperatives grow industrial crops, such as coffee or sugarcane or cotton, ISTA suggests that these will usually be grown on collective units.[40] Even then, ISTA suggests that each member family should have an individual parcel on which family workers can have some year-round employment. However, we recommend that ISTA's leadership and some leaders of campesino organizations visit Costa Rica to see for themselves that it is perfectly possible to produce coffee efficiently on family parcels.

3.3.6 An Alternative: Spin Off Extra Land to Form Another Project.

ISTA staff should insist that groups with above-average land per member admit refugees, displaced persons or other landless workers as new members. Those that refuse should be compelled to spin off some of their land, as the price of consolidating their debts. Thus the landless can be accommodated by setting up new cooperatives or individual parcels for them. Of course, the debts would be divided by ISTA, according to the area and soil quality of each portion. The original members would thus see their debts reduced, in proportion to the amount of land spun off.

As a further inducement to give up excess land, ISTA should also offer to reduce the overdue production debts of the present members in proportion to the land they give up. The new members would normally be glad to assume their share of these simply as part of the price, which would still normally be far below the market price of similar land today. The new members coming onto the land thus made available, would also be protected by the fact that the land price and debt payments could not exceed the rental market value of the land, so the arrangement would not abuse them.

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[40] This insistence, by Right, Left and Center in Salvadoran thought, is puzzling. Costa Rica demonstrates that coffee can be grown quite efficiently in parcels of 5 to 10 manzanas, on which all the labor is provided by the family that owns the parcel. Since there are no cash wage costs, Costa Ricans can produce coffee even when world prices fall so low that traditional growers in other Central American countries, relying on wage labor, cannot break even.

Chapter Four

GOVERNMENT POLICY PROPOSALS CONCERNING BENEFICIARY DEBTS

4.1 A Buy-out of Part or All of the Bank Loans

The debts of the land reform beneficiaries are of concern in two dimensions, only partly overlapping. On the one hand, the nationalized commercial banks are insolvent. The Government of El Salvador would like to privatize them, and to make them more attractive to possible buyers, it would like to clean up their portfolios. Much of the portfolios consists of non-performing loans, some of which were made to ISTA cooperatives, so the Government is interested in getting those loans off the banks' books.

On the other hand, the land reform agency (and the beneficiaries) would also like to see overdue production loans disappear. The accumulated debt load of many ISTA cooperatives appears very onerous to many of the beneficiaries. Also, some members believe they got little benefit from past borrowings; some accuse Board members or GOES functionaries of theft.

Others say the cooperative was simply mismanaged, but it wasn't their fault, and they don't want to repay the production loans that were squandered. Many members doubt that they will ever be able to pay off their share of old production debts, let alone the land debt, and become solvent, independent small farmers.

Under ISTA's plan, reform beneficiaries who choose well-defined property rights in land (whether individual parcels or clearly-defined negotiable shares in farm enterprises) will have to accept well-defined responsibilities as well. The biggest responsibility, in most cases, will be a share of the debts now owed by the ISTA cooperative that is to be reorganized.

When those accumulated debts are very heavy in relation to the income-generating potential of the land, it will be difficult to reach consensus on a fair allocation of the debts among the beneficiaries. Also, if faced with a seemingly impossible load of debt from day one, many beneficiaries may be so discouraged they will not want to abandon the present cooperative, even if they consider it inefficient. After all, it has maintained a certain level of social benefits without demanding (or getting) much effort or productivity from the members. Also, most cooperatives allow members to use at least some land for their own crops, often rent-free. Faced with truly heavy debts from the past, many may prefer the inefficient status quo over a straight-forward proportional distribution of land and debts.

Various consultants have looked at El Salvador's banks, and at the land reform cooperatives' debts.[41] All agree that it would be a good thing if the non-performing debts were collected or written off. Alas, none of them found a source of real resources with which to pay the debts, nor a source of the strength needed to collect them from the borrowers.

The banks have non-performing loans greater than their capital and reserves. In order to avoid the embarrassment of admitting negative net worth,[42] the Government refuses to force the banks to write off the non-performing loans. The borrowers, including prominent politicians, many non-reform sector businessmen and individuals, and some land reform cooperatives, insist that they cannot repay out of current income, and they do not have liquid assets to sell in order to repay.

With respect to the reform cooperatives, ISTA has guaranteed much of this credit, and ISTA, though a Government institution, has little budget support and no money with which to make good on the guarantee. The banks do not have mortgage liens on the land; they cannot foreclose, evict the

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[41] Among the reports examined, the following were especially helpful: Isaac Torrijos (1989), R. Schmidt and C. P. Zeitinger (CENITEC), and Claudio Skármeta and Onofre Torres (IMCC).

[42] This reluctance is puzzling, since it could be blamed on the previous governments and on the war. The situation somewhat resembles U. S. savings & loan associations that found bi-partisan Congressional support to postpone the inevitable debacle.

beneficiaries, and sell the land to the highest bidder. In any case, banks in El Salvador seldom foreclose on anyone's collateral. If unwilling to sue wealthy urban residents, politically the banks could hardly begin with the land assigned to the rural poor.

And so the various consultants have urged that "someone" provide a large infusion of new capital for the banks, from "somewhere." Most of their terms of reference required them to specify the source of the needed resources; most consultant reports failed to find one. (A few suggested tax increases, but did not go into detail as to rates, bases, and the political means to achieve implementation of the tax increase.)

Unable to find a giant tooth fairy to fill the giant cavity in the banking system, the Government of El Salvador has come up with a plan to shove the problem a little farther into the future. The idea is not entirely crazy. If that future includes an end to the war and an economic boom, the resulting increase in revenues from existing taxes might just help solve the crisis, unless, of course, it is spent on other urgent, long-postponed needs.

Unable to locate real resources, the Government now proposes to create still more claims on future resources, and turn those claims over to the banks to bolster their balance sheets. Essentially, the Government would issue new 10-year bonds paying 14% interest. These would be given to each bank in amounts sufficient to cover the non-performing loans.[43] The bank's assets would increase by enough to allow the banks to create accounting reserves equal to the non-performing loans. At that point, the banks would again have

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[43] This is the most startling aspect of the proposal as I understand it. By issuing bonds as needed to cover non-performing loans, the plan gives the greatest rewards to the worst-run banks, and to the banks that have failed most miserably to collect the loans they have made. Nothing in the plan requires anyone to actually collect the non-performing loans from the borrowers, any more than the state-owned banks did. In effect, the borrowers may get off free, and the biggest borrowers may get away with the most. Since the Salvadoran taxpayer will eventually pay off the bonds, this forgiveness is not just a boon to the bank managements. It is also a huge subsidy to the persons who succeeded in borrowing the most money, and get away with not paying it back.

a positive net worth, and the Government could hope to find private buyers willing to pay something to take the banks off the Government's hands.[44]

A giant flaw in the "bonding out" scheme is that it gives the biggest subsidies to the banks whose managers and clients are the worst performers. Banks that have been better managed will get far fewer bonds and hence, less subsidy in future years, than banks that were appallingly badly run.[45]

In any event, and regardless of the eventual fate of the bank bond bailout scheme, ISTA proposes to offer land reform beneficiaries a way to escape their accumulated debts, in those cases in which those debts are truly beyond their campesinos' ability to pay. Basically, ISTA itself will issue bonds to the banks in exchange for the overdue loans to ISTA cooperatives. However, once ISTA owns the overdue loans, it will offer a workout plan to the campesinos, based on the going rate for rental of farm land in the region.

4.2 Consolidating Beneficiary Debts; the Rental Value Option

ISTA proposes, as part of the analysis and discussion leading up to the restructuring of each cooperative, to consolidate all debts -- for the land, and for all unpaid past production and investment loans -- into one sum, to be repaid over 30 years at 6% interest, with four years of grace in principal repayment to be invoked whenever a crop failure, drought, or the like justifies it.

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[44] As far as I can determine, those in charge of privatizing the banks have not considered the obvious alternative: Auction the banks, with bidders competing to see who would demand the smallest amount to take over each given bank, complete with all its present portfolio. Bidders could compete to offer the package they would like best, ranging from small amounts of real money and no bonds, to no cash but large amounts of promised future money through packets of government bonds. Bidders should be encouraged to offer the government several different plans, any of which the bidder would agree to as his "price" to accept 100% ownership of the bank.

[45] The "bonding out" scheme, though justified as a means of facilitating the privatizing of the former commercial banks nationalized in 1980, will also refloat the balance sheets of the Banco Hipotecario and the Banco de Fomento Agropecuario. It will do this even though both were already state-owned in 1980, and no one is proposing to privatize either of them at this time. Their big borrowers who have failed to repay, and their managers who failed to collect overdues, will be bailed out by Salvadoran taxpayers, just as will the big borrowers and poor managers at the commercial banks.

In addition, the beneficiaries could also negotiate a switch from the payment required on those terms, to a simple annual payment based on the going rate of rent for farm land in the area, if that were less. The ISTA leadership has suggested values per manzana per year which seem quite low, as compared with those used by FINATA in its calculations, so it is likely that the "rental equivalent" offer would amount to a substantial reduction in the debt overhang in a majority of cases, for early years.[46]

4.3 Allocation of the Debts under new Tenure forms

When a partnership or company is divided among its owners, there is little mystery about the techniques required to allocate assets and liabilities. If they do not have a contract specifying terms in advance, they have to hammer out an agreement or a higher authority will impose one. The normal solution will reflect a proportional sharing of assets and liabilities among all owners.

4.3.1 Individual Parcels of Equal Value. This is probably the simplest case. An effort will be made to lay out the land in parcels of reasonably equal value. When a parcel includes sloping land of poor quality, more manzanas will be included in a parcel than when the soil is rich, deep and flat. Irrigated parcels can be much smaller than unirrigated parcels, and be of similar value.

The proposal under consideration calls for equal division among beneficiaries, allocating specific parcels by lottery, and allowing beneficiaries to swap parcels among themselves as they wish after the lottery. A variant that would be worth consideration would instead have participants draw lots to determine the order in which each would choose his parcel from all

[46] The proposal is vague on whether and how the annual rental rate is to be adjusted from year to year. If it is not adjusted, then inflation at the current yearly rate in excess of 20% would quickly turn the payments into nominal sums. ISTA's problem then would be to meet its operating costs, but these might be falling as the agency winds up its affairs. It would still have to service the agrarian reform bonds out, but they do not have index clauses against inflation either.

If the rental rate is adjusted from year to year, then in the present inflation, the straight debt at 6% over 30 years, with no indexing, would soon entail annual payments that would be lower than the prevailing land rentals.

parcels that had not yet been claimed. Either system is likely to be fair, and I recommend that ISTA just make sure the campesinos understand both systems and any variants on them that they may wish to propose, and then let the campesinos themselves decide which method they wish to employ.

In this case, along with each parcel would go an equal share in the total accumulated debts of the cooperative. The beneficiary would assume his share in the form of an individual mortgage lien on his parcel; annual payments would either be quotas under the 30-year, 6% payoff plan or rent-equivalents under ISTA's alternative plan.

4.3.2 Individual Parcels of Different Size and Value. In cases in which the debts come close to the market value of the land, ISTA might well ask the beneficiaries in a given cooperative whether they actually want equal parcels. In some cases, there might be sentiment in favor of a mixture of larger parcels (with larger debts) and smaller parcels (with smaller debts).[47] Such a solution would suggest the second form of lottery also: let members draw to determine the order in which they choose among available parcels.

In effect, this variety in parcel size merely anticipates the eventual result of normal buying, selling and trading among beneficiaries, that can be expected once they are true small farmers with full property rights. Because it will be criticized as unfair by those who seek things to criticize, it should probably be done only where the beneficiaries themselves strongly prefer it.

4.3.3 Collective Enterprises with Real Participation. In this model, the debt remains basically with the enterprise, and the consolidated amount becomes the long-term debt of the cooperative. (Often, titles to houses and immediate garden space will be issued individually; they should normally come

[47] Something like this was done administratively under Gen. Pinochet, as part of the liquidation of many land reform units in Chile in 1974. Farms were deliberately divided into a few larger parcels and many tiny house sites, thereby re-establishing a stratified social system and assuring the owners of larger parcels a readily-available supply of wage laborers. This precedent is by no means a recommendation, and may be a good political reason to reject anything but parcels of equal value.

with a small mortgage debt, the amount of which would be deducted from the debt of the enterprise at the moment of partition.)

The shares which the members receive will be similar to shares in many cooperatives or corporations. That is, when a member resigns, retires or dies, he can bequeath or sell his share. If he sells, it will be worth whatever a willing and eligible buyer[48] is willing to pay, no more and no less. That market value will reflect the desirability of owning the share, rather than any arithmetical or book value of assets minus liabilities.

If the share includes the right to employment at a good wage, the share will be worth more than if it doesn't. If it includes a cash dividend, the buyer may well agree to pay some multiple of the expected dividend. And if the debts are so heavy that neither guaranteed employment nor cash dividends come with the shares, they won't bring much -- but they are still tangible evidence of a property right that can at least be bequeathed or given someone else.

4.3.4 Mixed Enterprises. Basically, this is the same as the previous option. Members receive a share in a cooperative or collective enterprise, plus a parcel of their own. The debts are consolidated into one total, and then allocated in proportion to the estimated market value of the fixed and working capital. If the enterprise has assets worth C/ 20 million and the total market value of the parcels to be assigned individually is thought to be C/ 10 million, then the total debts are divided proportionally between the two sets. For instance, debts for a total of C/ 15 million would be divided as C/ 10 million for the enterprise and C/ 5 million allocated evenly among all the individual parcels.

[48] Because critics will inevitably raise the spectre of the former landowners buying up shares and reconstituting the former estates, it is likely that the cooperative By-Laws will impose some limitations on who is an eligible buyer of shares. For example, they may require that the buyer earn his living from agriculture, not have a university profession, and not own more than 10 manzanas of land elsewhere, nor own a house worth more than a specified value, and live close enough to be available for work if needed by the cooperative.

4.3.5 Collectives. Since this is basically a continuation of the status quo, the only innovation with respect to debts is the consolidation of the land debt and the accumulated overdues, refinancings, and other production and investment debt, into one long-term debt of the enterprise.
Individual member rights and responsibilities continue to be as defined in the By-Laws of the specific Cooperative.

To avoid a temptation to support the status quo where the benefits are currently too high to be sustained from net income, however, there should probably be a provision for government intervention and mandatory pruning of costly social programs whenever a cooperative has failed to repay its production credit for two or three years in a row.

ISTA should also insist, before formalizing the status quo and debt consolidation for such a cooperative, that the By-Laws require -- and the Board of Directors enforce -- payment of the going market rental for all land assigned members for individual or family cultivation. All land payments should be applied directly to the service of the long-term debt. Members unwilling to agree to this should abstain from using cooperative lands, and milpa lands then left idle could be rented to landless people in the area, with their payments going onto the debt service.

4.3.6 Cooperatives that are Divided into Two or More Units. In some cases, the present cooperatives should be divided into more compact units before they are distributed definitively. In cases of units with separate properties (such as Pasatiempo), this will greatly facilitate thinking by members about how they want to own and manage the land in the future. At present, in such cases, only the members of the Directiva have much of a grasp of the whole property.

In other cases, a cooperative does not have its fair share of members, and has been reluctant to accept more. In such cases, part of the land should be split off before resolution of the future organization for the main property among the present members.

In both of these cases, the Valuation and Acquisition Department of ISTA is quite able to appraise the land and improvements, and to assign a value to each portion. Normally, the long-term debt would be divided in direct proportion to those values. When part of the debt was incurred to build specific improvements, presumably it is reflected in the value of those improvements.

In the occasional case in which the investment was unsuccessful, just as in the case of the original or emergency loans that allegedly vanished, ISTA should just write off the amount of debt involved rather than attempt to allocate it to the ongoing cooperatives.

4.4 Concerns and Recommended Alternative Policy Actions

The ISTA proposal is a reasonable, gradual and sensible approach to the basic problem of defining economic rights and responsibilities, and of moving reform units toward incentives for efficient production. We have discussed some alternatives already with ISTA's leadership, and the latest version of the proposal already includes provision for two features that are attractive to members and at the same time promote efficiency: discounts for early repayment of debt, and life insurance for beneficiaries with individual parcels or house plots. The principal additional concern has to do with the appearance and substance of justice and economic sense among cooperatives, some of which have already made some payments, while others have not. In addition, it may be necessary to make adjustments as between new members and old, to reflect "sweat equity" built up by the older members.

4.4.1 Discounts for Pre-payment. The 6% interest rate charged on long-term debt is probably below the rate of inflation that will exist during most if not all of the next 30 years. Accordingly, the Government can well afford to give a discount for payment of quotas before they are due. FINATA had considerable success at encouraging beneficiaries to agree to repayment terms much shorter than the maximum allowed by law. Of course, when the agreed schedule is not met, then the balance due must be increased to reflect removal of the discount originally granted. FINATA is reportedly doing this in the renegotiation of overdue land debts of its own beneficiaries.

A few details are perhaps obvious: no borrower should be given a discount for prepayment of any quota, if a quota already due is unpaid. Secondly, the buyer who prepays should be reassured that if he later has a problem, the prepayment can be applied to help solve the problem. (This way, the buyer is not tempted to keep the money somewhere else rather than prepay.)

For instance, contracts could provide that every C/ 100 paid before it was due would reduce the remaining debt by C/ 120 if it was paid one year early, and C/ 140 if it was paid two or more years early. However, the borrower would be entitled to come in at any anniversary and say that the annual quota then due, was to be covered by the same number of colones that he had paid ahead of schedule earlier on. (In this case, the extra credit is canceled, but at least he is recorded as being current in debt repayment.)

This feature would be in addition to the flexible four grace years in ISTA's plan, which are to be used when there is a crop disaster. When there has been prepayment of one or more quotas, the debtor would not be required to prove a disaster; it would be an earned right to apply the early payment to a subsequent annual quota just because he wanted to do so.

4.4.2 Credit Life Insurance. When a small borrower dies or is severely disabled by illness or accident, it is very difficult to evict the family, and yet the family may be quite unable to continue the payments as scheduled. Lenders have learned, in other countries, that it is better to just build in a life insurance provision that covers the unpaid debt in such cases. When the specific person named in the debt paperwork suffers death or total disability, problems are avoided and much good will is generated by a highly public presentation of a "paid in full" certificate to the widow.

This provision is appropriate for individual parcels, and for the individual house plots that are provided under the mixed plans. It is not needed for the share in the collective enterprise, nor for the totally collective (status quo) arrangement, because there the debts are of the firm, not of the individual. When a shareholder dies, his family receives his share and holds or sells it, but the debt is not affected. Another worker is hired -- perhaps a family member, especially if the share implies preference in hiring -- but the enterprise carries on.[49]

There is little need for the cost and formality of an actual insurance policy, because ISTA and FINATA have enough debtors that its risk is well

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[49] Many cooperatives have some version of a death benefit, widow's benefit, or disability benefit for their members. See PERA-CLUSA, 1985. The individual life insurance provision merely replaces that benefit, when a cooperative divides its land into individual parcels.

diversified already. Obviously, to avoid abuse, there should probably be a provision that no one could be covered under such a plan unless at the time of the reorganization he is certified by the cooperative directors as being in reasonable health and able to work.

4.4.3 Credit for Payments Already Made. Not many cooperatives have made significant payments on their land debts so far; a total of some C/ 32 million has been paid. Nonetheless, ISTA should be very explicit in stating that the long-term debt will be reduced in all such cases. Likewise, those cooperatives that have repaid their production loans will have much less total long-term debt than others that have not.

In calculating the alternative, of paying each year according to the going land rental rate in the area, it would be unfortunate if a cooperative that had paid something on its land debt wound up with yearly payments as high as another cooperative that had paid nothing. (That would probably indicate that the assumed land rental price was not really a market value.) Should this happen, some discount for prepayment would be in order, just as would be given for future payment of quotas before the due dates.

4.4.4 Terms for the Entry of New Members. In many cases, Cooperatives are a blend of pioneering members who were there in 1980, and of their sons or other persons who came in subsequently. When discussing the terms of reorganization for the future, it would be appropriate to allow consideration of recognition for "sweat equity" built up by the older members, to the extent that equity was actually built up.

That is, if payments were made on the land debt, if the initial loans were repaid and production and investment credits are current, then it is likely that some actual net worth has been built up. In such cases, the debts that accompany each parcel, house plot, or share in a collective enterprise will be smaller than where no equity has been built up.

However, it is not necessarily fair that a member who entered just last year receive the same share in net worth as a member who entered in 1980, unless all the increase in net worth took place in the last year.

It is important that the beneficiaries regard the process as fair. Therefore, where net worth has in fact been built up, it would be reasonable to recognize this in some fashion where membership has changed. The records are seldom good enough to allow perfect accounting for such cases, but at least some gesture may be in order. As between father and son or daughter, it may be assumed fair enough that the net worth was inherited. But when total strangers enter, they could reasonably reimburse older members for such past efforts.

For example, if a given cooperative paid off C/ 100,000 in land debt in 1984, but nothing before or since, that sum might be credited to the land debts of the present members who were also members in 1984 (or whose parents were). Those who became members after 1984 would pay the full share of the original debt, with no deduction for the payment on account, which did not reflect any sacrifice on their part.

Perfect equity among members, where there has been much turnover and sloppy record keeping, is not attainable. But a gesture toward equity in the few cooperatives that have made land payments, with sacrifice by those who were members at the time, could increase the sense that the whole process is fair.

Chapter Five

Agrarian Reform Debts and Privatization of the Banks

The Government of El Salvador proposes to privatize the nine commercial banks that were nationalized in 1980. According to one document (GOES 1989) the process would begin with three banks: Cuscatlán, Comercio, and Agrícola Comercial, in March 1990, with the rest to follow in July. The dates have slipped, in part because the plan called for the state to purchase the overdue loan portfolios before the end of February 1990, and that has not yet happened. The purpose of this purchase would be to restore the nominal net worth of each bank to the previous (Nov. 1989) level, after substantial increases in the provision for bad debts.

5.1 Specific Proposals to "Bond Out" Doubtful Loans:

Specifically, each of the nine commercial banks plus the Banco Hipotecario was to raise its reserves for uncollectible loans to cover a realistic level of probable losses. A draft bulletin from the Banco Central de Reserve defined that as 10% of those classified as "C" risks, 50% of those classified "D" and 100% of those classified "E" in the recent evaluation of bank portfolios carried out by consultants from Citibank.

Creating reserves at this level would leave all of the banks with negative net worth, which the Government thought would make it hard to sell their shares to the public in order to privatize the banks. The Government is therefore disposed to buy the portfolios -- the same loans for which reserves have been constituted. The result is that neither the loans themselves nor the reserves would be on the banks' books any more.

By "bonding out" the uncollectible debts, the Government would restore the net worth stated by the Banks as of November 1989. (This net worth was exaggerated, precisely because reserves for uncollectible loans were grossly inadequate.)

It is unclear whether the scheme would even "bond out" the bad loans already covered by reserves already established, thus increasing the apparent net worth of each bank.

In payment, the Government would give each bank the necessary amount of money in the form of long-term 14% interest Government bonds at par. The more each bank had to increase its reserve for uncollectible loans, the more bonds it would receive -- and the more of its loans would pass to government ownership.

The Government would leave the actual loans in the banks, with a contract under which the bank would continue to manage that portfolio. Presumably, if any of these risky loans were actually collected, the bank would notify the Government, which could then reduce by that amount the money to be paid to the bank that year in principal and interest on the bonds issued to that bank. Alternatively, the bank could return an equivalent amount of bonds to the Government, while still collecting the full interest and principal reduction due that year on the rest of the bonds. The documents reviewed are silent as to management fees to be collected by the banks for servicing what has now become the Government's portfolio.

The documents reviewed have also been silent as to how to decide which 10% of the Class C risks and which 50% of the Class D risk loans are to be bought by the Government. They are equally silent as to how to sort out those bad loans for which the banks had already made provisions; would those be "bonded out" too, or would the subsidy be limited to loans for which the banks had not already made provision?

Obviously, if the subsidy is limited to loans not already provided for, then the banks that made the most effort in the past to create appropriate reserves, will be punished for their prudence. Yet if those loans are "bonded out" along with the rest, the net effect will be to increase the stated net worth of each bank by the amount of the reserves previously constituted. In terms of rewards for sound banking, one would prefer this outcome, if the Government of El Salvador is determined to give a large taxpayer subsidy to the banks in general.

5.2 Who Would Really Fund the Privatization?

From the Government's point of view, "bonding out" has the huge advantage of requiring no real resources at this time. Only interest is to be paid for the first two years; principal repayments commence in year 3. The bonds are to be issued in series of 5, 10 and 15 years, according to the December 1989 proposal.

When the interest and principal repayments do fall due, their service will require real resources. The proposal states that these will come from tax revenues or from foreign sources, not otherwise specified.

I have not been able to detect any "foreign" source, so it must be assumed that the bond service is to come from Salvadoran tax revenues or from deficit finance; the latter is an indirect tax through inflation, and could create serious problems in relations with international financial institutions.

5.3 Use of the Proceeds of Privatization of the Banks.

There is one other modest source of real resources potentially available to help service the new bonds to be issued. That is the amount that investors might pay for shares in the banks to be privatized. If this amount were to be earmarked for service on the bonds that helped make the banks more attractive, it would seem more than appropriate.

It is a matter for judgment whether a subsidy in the form of the service over 15 years for bonds with a face value of C/ 3 billion when issued, would increase the price at which the bank shares could be sold by anywhere near that amount. To this observer, it seems unlikely. However, the market price of these shares will depend on many other factors. For instance, will stockholders be able -- as in the past -- to get preferential access to personal and business credit, while other would-be borrowers are turned down?

It is also unclear from the documents reviewed, whether there are already priority claimants for the proceeds of the sale of bank shares. For instance, are there claims still pending from the former stockholders of the same banks, nationalized by law in 1980?

5.4 Delinquent Loans to Agrarian Reform Beneficiaries are a Minuscule Part of the Problems of Salvadoran Banks.

Table 9 compares the delinquent loans of the reform sector with all delinquent loans; the reform sector is a tiny part of the problem.

Table 9

Non-Performing and Doubtful Loans, by Banks, Agrarian Reform Sector and All Other Borrowers, late 1989

Bank	Recommended Write-Downs	% of Total Portfolio	Doubtful A. R. Loans	% of Write Downs	% of Total
	(1)	(2)	(3)	(4)	(5)
Agrícola Comercial	549.6	38.9%	16.3	3.0%	1.2%
Capitalizador	279.9	40.8	5.0	1.8	0.3
Comercio	246.7	25.6	13.3	5.4	1.3
Crédito Popular	355.5	46.3	10.7	3.0	0.8
Cuscatlán	274.8	15.3	16.2	5.9	2.9
Desarrollo e Inversiones	97.5	37.4	2.8	2.9	0.1
Financiero	10.7	11.6	0.0	0.0	0.0
Hipotecario	950.4	59.8	50.0	5.3	8.0
Mercantil	59.6	29.8	1.4	2.3	0.0
Salvadoreño	258.4	26.0	18.3	7.1	1.8
Totals*	C/ 3,083.0	35.2%	C/134.0	4.3%	1.5%

* Note: Does not include credit extended by the Coffee Institute (INCAFE), the Agricultural Development Bank, nor by FEDECASES, a federation of credit unions.

Sources:

Col. 1 - USAID-1989-b, p. 7. 50% of Class D + 100% of Class E loans.
Col. 2 - USAID-1989-b, p. 7. Compared to total loan portfolio of each bank.
Col. 3 - Delinquent = overdues plus refinancings.
Col. 4 - Calculated from above.
Col. 5 - Calculated from above.

5.5 Possible Consequences of the "Bonding Out" Scheme

The "bonding out" scheme presents some obvious advantages and some very significant potential problems. First, it improves the balance sheets of the banks, making them potentially sound institutions. Second, it does not require real resources this year, nor significant amounts of real resources for two years more. Third, it will no doubt make it easier to sell shares in the banks to the public, although the amount received is unlikely to be nearly as great as the subsidy given.

The problems are significant. They include at least the following:

5.5.1 The Subsidy will be a Significant Burden on Taxpayers.

At 14% interest, the interest alone on C/3 billion in bonds comes to C/ 420 million a year (about US $53 million at present exchange rates). That is not insignificant.

Depending on the mix among 5, 10 and 15 year bonds, after the initial two-year grace period expires, the repayment of principal will increase the taxpayers' burden considerably.

5.5.2 The Bonds will not Create Actual Lending Power.

The Salvadoran banks will hold Government bonds in place of delinquent loans, but this fact in itself will not increase real resources that the banking system can lend to worthwhile projects. One document suggests that "bonding out" converts interest accrued but not collected into interest "collected," and that this "income" can then be used to increase paid-in capital and reserves. In turn, that would increase the amount of money the banks could lend under El Salvador's 8% reserve requirement for loans outstanding.

The trouble with this reasoning is that the reserve requirement could also be changed without going to the trouble and huge taxpayer expense of bonding out the doubtful loans. A similar increase in loanable funds could be obtained by changing the required ratio of paid-in capital and reserves to loans. In either case, the monetary authorities must allow for any increased ability of the banks to create money in circulation, in setting overall monetary policies.

Later, when interest and principal are paid on the bonds -- _if_ they are paid -- then the banks receive real resources which they can lend. Of course, that would be true at any time that the banks receive real money from any source. For instance, the Government could also give the delinquent debtors real money with which to repay their overdue loans.

5.5.3 The Greatest Subsidy Goes to the Worst Performers.

There is a serious problem of perverse incentives in the proposal as now written. The quantity of bonds issued and given outright to each bank will depend on the quantity of bad loans outstanding at that bank. The more loans made rashly, without adequate collateral, the greater the bailout by the taxpayers. Worse, the bank officials themselves are largely able to say which loans are bad. Their incentive will be to exaggerate the problem and lengthen the list, since that will increase the subsidy they get.

On top of that, they will have a contract to administer the bad loan portfolio the government buys from them -- so they can earn greater fees by putting more loans into the "bonding out" portfolio. While they are able to earn more than 14% interest on their loans, they will have no trouble finding borrowers for any loanable funds available. Thus it will be to their advantage for officers to "bond out" every loan delinquent even for a few days. And if the loan is in fact "good," it will make their administrative efforts look more successful when they collect it -- thus justifying their management fees.

5.6 Possible Alternatives to the Bonding Out Scheme.

The Government document proposes that in a later stage, the Government should also rehabilitate those debtor enterprises that can be salvaged if their credit is restored by the "bonding out." This appears to mean that the Government is prepared to forgive, or write off, substantial amounts of delinquent loans once the Government owns them.

5.6.1 Give the Cash or Bonds Directly to Debtor Enterprises.

The most obvious alternative policy would have the Government give cash or bonds to the banks on behalf of the debtor enterprises, after investigation had declared the cause of their inability to pay to be genuinely beyond their control. This would clear up the overdue loans, and improve the credit rating of the enterprises. It would simultaneously reduce the need for establishing bad loan reserves, and convert accrued interest into income, enabling the bank to increase its capital and reserves and hence its loan capacity. In short, it would do everything the bonding out scheme does, and rehabilitate the enterprise rather than only the bank.

To the extent that the delinquent debt problem in El Salvador stems from the civil conflict, there is a precedent in Northern Ireland: the Government of the United Kingdom routinely pays cash or forgives government loans to companies whose factories are damaged by terrorist bombs. The payment is tied to actual unforeseen losses traceable to the violence. No payment is made for simple managerial incompetence or slothfulness.

5.6.2 The ISTA Proposal Accomplishes Much the Same Result.

For the agrarian reform beneficiaries, the recommendations made in Chapter 4, above, accomplish much the same objective. First, ISTA would write off the initial loans, or Cartera, that are uncollectible. The banks are not involved in this; ISTA already owns those loans.

Second, ISTA would pay off loans outstanding to cooperatives that have been abandoned, or where there has been a complete turnover and the money borrowed cannot be shown to have benefitted the present members. Chances are that most of those loans have already been placed under the FFRAP system, unless this has been impossible because there was no one to represent the borrower.

Third, ISTA would issue bonds to the banks in exchange for any overdue loans not already financed under the FFRAP scheme. It might especially buy any loans delinquent because violence associated with the civil war or natural disasters such as drought and flood made it impossible for the cooperative to repay. This is comparable to the payments suggested directly to industrial or commercial enterprises affected by the war.

Fourth, ISTA would allow the members of any cooperative that could not repay its total debts (land, investment and overdue production credit) with less than 30 years of the going rate of land rents in the area, to pay that amount instead. This is a partial write-down, that should appear quite fair to the beneficiaries.

Meanwhile, the lending bank has received ISTA 6% bonds in payment of all of its overdue loans to ISTA beneficiaries. The bank in turn can convert these, as well as the FFRAP bonds it already holds, into 14% bonds when the Government gets its general "bonding out" scheme in place.

In effect, ISTA's plan will accomplish the same thing as if it had given ISTA bonds to meritorious reform beneficiaries, and persuaded the banks to accept them in full payment of the overdue debts.

5.7 A Proposed Guarantee Scheme for Future Credit

Other documents reviewed suggest that need for a guarantee scheme to encourage banks to make loans to land reform beneficiaries in the future. In interviews in El Salvador, I was told that the expectation was that local currency could be used to create such a fund. Since "it would not actually be used," the money would be as good as sterilized, and would not create inflationary pressures.

The missing element in those documents and interviews was any mechanism to guarantee that the Guarantee fund would not in fact be disbursed. The risks to be covered are at least these:

5.7.1 Risks of Acts of War. Acts of arson and other violence may cause any borrower to be unable to repay loans. There is much to be said for creating a fund to encourage investment by compensating investors, including small farmers, who are victims. But it should not be assumed that this fund will not be used, unless peace is actually achieved.

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effective mechanism to replenish the Fund by collecting from the delinquent debtor.

Thus far, the only successful method yet demonstrated over a sustained period has been one that functions in some parts of the Dominican Republic. In this system, various farmers co-sign each other's debts -- and agree to "rules" under which a loan not repaid by one is actually repaid by the others, but they in turn effectively seize his land and run it themselves.[50]

Until such a system is in place, it must be expected that a Guarantee Fund will have claims. Yet the creation of such a "solidarity" system might usefully be furthered by having the Guarantee Fund as a type of "reinsurance" available to back loans made to co-signer groups.

If there were a general failure to repay of a group, then ISTA should probably execute the lien it holds, or the lending bank could foreclose in the traditional way, and ISTA or the bank could resell the parcel, parcels or cooperative to other campesinos willing to assume the unpaid debts as part of the price of the land.

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[50] This method has recently been evaluated in the Dominican Republic, where it is common in the rice-growing cooperatives. These operate as "Associative Cooperatives," similar to condominium buildings in cities. That is, heavy plowing and certain other tasks with scale economies are done by the group for all members. Credit is wholesaled to the group, which guarantees repayment to the bank. And when a member fails to produce enough rice to repay his loan, the group seizes his land, without legal formalities, costs or delays.

The group decides whether the debtor deserves another chance; if so, he becomes a day laborer on his own parcel, under their supervision, so he learns how to be more productive. If not, he is forced to leave, and the parcel is turned over to a family member or is farmed by the group, using hired labor, until the parcel has produced enough profit to repay the overdue loan (to the group, which already paid the bank). This method has now worked successfully for more than five years, in the Dominican Republic. Part of the success, of course, is that only a few members suffer losses in any given year. The land is irrigated, and there is a good market for the product. But a real part of the 100% collection rate lies in a practical, low-cost, politically acceptable, effective substitute for foreclosure. The Dominican system also has the enormous social benefit that after the debt is paid, the beneficiary gets the parcel back.

For more details, see John Strasma, "Peer Intervention" as an Effective, Low Transactions Cost Method of Collecting Agricultural Loans in Developing Countries. Madison: University of Wisconsin Department of Agricultural Economics Staff Paper, July 1990.

Chapter Six

Compensation for Expropriated Land: Status of the Bonds

6.1 Amounts and Form of Compensation Paid

Former landowners are compensated, in the Salvadoran agrarian reform, with small amounts of cash but principally with long-term bonds. The bonds are in four series: Class A, B, and C, and a Preferential Class A, maturing in 20, 25, 30, and 5 years, respectively. The interest is to be paid annually, in May, at 6% for all except the Preferential Class A's, which earned 7% during their brief life.

When banks had made loans to landowners against land mortgages as collateral, the banks were required to accept the bonds toward payment of principal and interest due on those loans. The mortgage lien, however, disappeared -- whether or not the nominal value of the bonds was sufficient to repay the full amount, including back interest, due on the original loan. To compensate the banks for the loss in interest (the bank loans usually accrued interest at 14% or more), banks (but not other bondholders) are allowed to exchange bonds received for other "compensatory" bonds yielding 12% annual interest and maturing more quickly than the original bonds. As of March 31, 1989, some C/ 130.5 million in bonds had been converted from the 6% and 7% series into the "compensatory" series at 12% interest.

6.1.1 Bonds Issued Thus Far:

Through December 31, 1989, ISTA's Board of Director had approved the acquisition of 456 properties for prices totalling C/ 767.4 million. Of this, a little over 8% was paid in cash, and the balance in bonds, mainly of Series A (20 years, 6%). By March 12, 1990, ISTA had paid for 457 properties, with a total of C/ 767.8 million in cash and bonds, divided as shown in Table 10:

Table 10

Compensation to Former Landowners, Phase I
(Refers to 457 properties paid for through March 12, 1990)

Form of Payment		Amount
Cash		C/ 64,550,793.80
Bonds, as follows:		
Series A, "Preference" (5 yrs, 7% interest)	C/ 66,612,100	
Series A, regular (20 years, 6% interest)	558,002,000	
Series B, regular (25 years, 6% interest)	23,795,100	
Series C, regular (30 years, 6% interest)	54,836,300	
Total Bonds		703,245,500.00
Total Compensation Paid by ISTA[51]		C/ 767,796,293.80

Source: ISTA, Estado de la Deuda Bancaria y Agraria de las Cooperativas de la Reforma Agraria, Fase I. San Salvador, Marzo 1990, p. 7.

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[51] In ISTA's reports, land is paid for when ISTA delivers the bonds to the Fiscal Agency at the Central Bank. The former landowner (or his bank) must bring in the Provisional Certificate issued by ISTA and exchange it for the bonds; it is up to the bondholder then to try to collect the interest and principal as they fall due. It is much less clear who is responsible for delivering actual money to the Fiscal Agency for the actual payment, in money, of the interest and principal as they fall due. On paper, ISTA is obliged to do so, but the bonds also carry the "unlimited and subsidiary commitment of the Government of El Salvador" to make that payment. In practice, the money delivered to the Fiscal Agency often falls short of the amount needed to pay interest and principal then due, and bondholders have not discovered an effective way to collect on that government commitment. Partial relief is available, however, in that interest coupons and bonds, once matured, may be used to pay taxes at face value. Even before maturity, bonds may be used at face value to pay inheritance and gift taxes. This, plus the fact that the Government owns all the banks and the banks hold about a third of the bonds, may explain why there has been no huge protest when interest coupons were not paid at once upon their maturity. According to the Fiscal Agent, in 1988, the loudest protest he received came from the Minister of Finance, who demanded that the Fiscal Agent pay cash to "redeem" the coupons that had been received in payment of taxes. The Agent stated that he would be glad to, if the Minister (or ISTA or anyone else) would provide him with the funds!

When ISTA authorizes a transaction, an intermediate step is the issuing of a Provisional Certificate, which the bond recipient is supposed to exchange at the Central Bank (BCR) for the definitive bonds themselves, in the appropriate combination of denominations, classes, etc. Curiously, as of March 31, 1989, the Central Bank reported that about 12% of the Provisional Certificates issued had not yet been converted. The bonds it held for this purpose, some C/ 81.8 million, still had all their interest coupons as well; the bondholders had not even attempted to collect interest accrued to date.

Unofficially, it was thought that these certificates were in the hands of the banks, and many of them specifically in the hands of the Agricultural Development Bank (BFA). Former landowners complain occasionally that the banks, by not converting the certificates into bonds and crediting the accounts of the former landowners for the debts they used to owe on the same land, needlessly show them as still delinquent in paying their debts to the same banks. It is not clear whether this is inefficiency at the banks, or possibly a preference to continue accruing interest on the old loans to the former landowner (at a rate higher than the 12% that the "compensatory" bonds yield).

This is relevant to the "bonding out" proposals, because some of those apparently uncollectible loans to the banks may actually have been paid. That is, the bank itself may have failed to turn in the Provisional Certificate from ISTA, to get bonds and interest coupons, and thus may have failed to credit the debtor's account for the indemnization paid by ISTA or FINATA for the land that used to be security for a loan.

If ISTA bonds are used to "bond out" debts that have already been paid, the figures will be needlessly inflated. This is especially likely to happen at the BFA, if it is true that the BFA still holds large quantities of Provisional Certificates that it hasn't bothered to exchange for ISTA bonds, and then to exchange the ISTA bonds for "compensatory" 12% bonds. The debtor himself may not have looked into the matter, because he may have moved to Miami or otherwise no longer be paying any attention to communications from the bank claiming that he still owes on the original loan that was guaranteed by land taken in the land reform.

The BFA and other banks still holding Provisional Certificates could instead convert the overdue debts into 14% bonds, if they just wait for the new proposal to come into effect. Slothfulness could be quite profitable. It would even mean that the banks would collect any "excess" owed by the debtor, above and beyond the debt and accrued interest that was paid in part with land reform bonds issued by ISTA or FINATA.

Bonds also disappear from circulation when they are used in payment of certain taxes; as of December 31, 1989, the Dirección General de Tesorería reported having received C/ 204.7 million in bonds for this purpose, or about 30% of all the bonds authorized to date.[52] At any rate, as of December 31, 1989, it appeared that about C/ 274.4 million, or 39% of the bonds issued to that point, were still in the hands of the public. None of these figures include the amount of interest paid or still due, which is discussed below.

6.1.2 Bonds Yet to be Issued, for Land Acquisitions Pending:

In addition, as of March 31, 1989 the Board had approved the acquisition of 16 more properties, but the owners had not yet agreed or had not completed the paperwork, involving another C/ 19.3 million, of which C/16.7 million was to be paid in bonds. Nine more properties were pending approval by the Board, for compensation which was expected to come to C/ 65 million, of which C/63.8 million would be in bonds. The total bond issue, when this was completed, would be C/ 750.17 million (USAID-1989a, p. 7).

As of March 12, 1990, the ISTA Board still had 20 properties approved but not paid, or awaiting approval, in order to complete Phase I of El Salvador's Agrarian Reform. ISTA estimated that this would require further payments, by May 19, 1990, as shown in Table 11:

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[52] The agrarian reform bonds are not the only Government obligations which carry Government guarantees that have not in fact been honored when due over the last ten years. Smaller amounts of bonds and interest coupons issued by other autonomous agencies have also gone unpaid. Many of those coupons have also been presented in payment of taxes as the only practical way to collect the payment supposedly "guaranteed" by the Government of El Salvador.

Table 11

Cash Requirements to Complete Payment for all Phase I Properties*

Requirement		Amount Needed
Cash, for machinery, inventories, etc.	C/	9,012,486.29
Interest coupons already due on bonds to be issued in payment for the land**		75,936,859.00
Total cash requirements, to complete payment for land acquired in Phase I:	C/	84,949,345.29

* ISTA considers the land paid for, when it delivers the bonds and any cash down payment to the Central Bank Fiscal Agency, whether or not the bonds and interest are in fact paid when due.

** The land was taken in 1980. Once terms are finally settled the bulk of the payment will be made in bonds dated May 19, 1980. All interest coupons that have already matured may be presented at once for payment; ISTA is seeking money with which to make those back interest payments.

Source: ISTA, Estado de la Deuda Bancaria y Agraria de las Cooperativas de la Reforma Agraria, Fase I. San Salvador, Marzo de 1990, p. 9.

6.1.3 Bonds Issued for Purposes Other Than Acquisition of Land:

ISTA has not in fact been constrained to use its bonds solely for payment of compensation to former landowners. It also issued C/ 400 million in bonds in 1989, to be given to banks in exchange for overdue loans to agrarian reform cooperatives and to other farm operators, whether or not they had anything to do with the agrarian reform. This program is known as the FFRAP: the Fund for the Financial Reactivation of Productive Activities; it is administered by the Banco Central de Reserva (BCR). Basically, the bonds are deposited with the commercial banks to guarantee eventual payment of their overdue loans to farmers, reform and otherwise. If and when the overdue loans are repaid, then the bank gives the bonds back to the Central Bank. And presumably, when the bonds eventually mature (20 years), the Government is supposed to pay them off, thus allowing the banks to write off the overdue agricultural loans as definitively uncollectible. Meanwhile, the bonds bear interest -- but lower than that theoretically accrued on the delinquent loans.

6.1.4 <u>ISTA's Proposed Use for its Remaining Bond Inventory</u>:

ISTA has been authorized to issue bonds for a total of C/1,600 million. Of that, C/1,335.7 million have actually been issued, so ISTA could still issue another C/ 264.3 million before it would have to seek authority from the Legislative Assembly to issue more bonds. Of the bonds already issued, C/ 1,289.1 million are needed for land payments and for payments to banks to cover cooperative overdue debts that were refinanced under the FFRAPP plan (C/ 400 million). Nonetheless, there should be C/ 46.6 million in bonds "left over" after this process.

The "leftovers" plus the C/ 264.3 million that could still be emitted under existing authority leave ISTA with some C/ 310.6 million in bonds that it could still issue. ISTA recently proposed to issue them as payment to the banking system for non-performing loans made to agrarian reform cooperatives. This was discussed in Chapter 4, above.

6.2 <u>Status of the Debt Service: Interest and Principal</u>:

The following is the status of debt service on the bonds issued for Phase I of the agrarian reform, as of December 31, 1989.

6.2.1 <u>Amounts Already Paid in Debt Service</u>:

C/ 498.0 million were needed, but the Central Bank (acting as Fiscal Agent) had received only C/ 357.3 million, of which it had disbursed C/ 343.4 million.

Another C/ 14.1 million were available and on hand, mainly for the redemption of the few remaining bonds of the "Series A, Preference" category.[53]

6.2.2 Amounts Still Needed to Get Bond Debt Service Up to Date:

As of December 31, 1989, the Central Bank (as Fiscal Agent) needed another C/ 245 million, most of it to complete payment of the interest coupons that had matured through 1989.[54]

By March 1990, and including the interest that will fall due on May 19, 1990, the shortfall is C/ 245.6 millions (ISTA 1990-a, p. 8). It is not clear as of March 1990, where this money is to come from, in spite of the "full and subsidiary guarantee of the Government of El Salvador." Table 12 shows the amounts available and the shortfall.

6.2.3 Amounts of Bonds and Coupons Received in Payment of Taxes:

As of December 31, 1989, the Treasury reported that it had received bonds worth C/ 204.7 million (at face value) in payment of various taxes. Not all were land reform bonds; the same privilege is available to holders of bonds issued for various kinds of public works. However, the vast majority of the bonds so received are land reform issues (ISTA and FINATA).

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[53] This series matured in just five years from the issue date (1980). Yet some have not been presented for payment. They may be bonds held by ISTA for owners who are still resisting settlement. They may be held by a bank that has not bothered to present them for payment. A few may have been used to pay taxes, though this seems irrational, as other bonds serve as well and are available freely in the market at about 62% of face value.

[54] Actually, the cash shortfall was only C/ 139 million in 1989, mainly because C/ 43.2 million in interest was accrued on bonds still at the BCR because their legitimate owners, mainly banks, had not yet presented the provisional certificates corresponding to those bonds. Of course, if the certificates had been presented and the bonds delivered, those interest coupons would have been immediately payable -- had there been any money with which to pay them, which there wasn't. The immediate cash needs in 1989 were also reduced by C/ 15.6 million deposited at the BCR, but not claimed, by persons entitled to cash payments (C/ 10.2 million) and to redemption of Series A "Preferred" bonds, due but not yet presented for payment (C/ 7.9 million). (USAID 1989-a, Table 6.)

Table 12

Requirements and Resources Available, for Service of the Agrarian Reform (Phase I) Debt, 1990

Item	Funds Needed	Funds Provided to the BCR so far (1)	Other Funds Budgeted(1)	Deficit
		-- in millions of colones --		
Cash for down payments	64.5	65.6	-	C/ (1.1)
Redemption of Series A, Preference bonds	73.5 (2)	70.0	-	3.5
Redemption of Series A regular bonds	40.0 (3)	-	-	40.0
Redemption of Financial Compensation bonds	20.0 (4)	7.0	C/ 5.0	8.0
Interest Due, through May 19, 1990	535.6	225.3	115.0	195.2
Totals	C/ 733.6	C/ 368.0	C/ 120.0	C/ 245.6

(1) Funds provided from 1980 to date came from the fiscal budget, from local currency controlled by USAID, and from payments by ISTA cooperatives. Budgeted funds are to come, during 1990, from the same sources.

(2) These were 5-year bonds; they matured May 19, 1985.

(3) This is the first installment due on principal, 10 years after the Series A bonds were emitted. The payment is due on May 19, 1990.

(4) This is the scheduled amortization of principal in May 1990, on the 12% "Financial Compensation" bonds issued to financial institutions in exchange for ISTA's land reform bonds. The banks were required by law to accept ISTA bonds at face value, as partial payment of overdue loans to the former landowners, when the land had been pledged as collateral. If the value assigned the land in compensation was less than the overdue loan and interest, the bank has to release the mortgage lien anyhow, and must look to the ex-landowner to pay the balance due on the original loan. However, banks (and only banks) are allowed to exchange ISTA bonds for others paying 12% interest and amortized over fewer years. The Salvadoran government is supposed to pay the extra interest, over the 6% interest and debt service ISTA was obliged to provide for the original bonds.

Source: ISTA, Estado de la Deuda Bancaria y Agraria de las Cooperativas de la Reforma Agraria, Fase I. San Salvador, Marzo de 1990, p. 8.

Unable to do anything else with these, the Ministry is disposed to make the same bonds available again to ISTA, for use in "bonding out" the overdue and refinanced debts of land reform cooperatives.

6.3 Bond Holdings in Relation to Bank Privatization:

One way in which the bank privatization could be facilitated, together with a general sanitizing of GOES overdues, would be to allow persons bidding for shares in the banks, to pay for them with land reform and other bonds. If the bonds were then retired by the government, as seller of the bank shares, the overdue bonded debt service would be reduced.

Alternatively, the shares could be issued by the banks, and the bonds given as payment would become assets of the banks privatized, just as if the buyers had paid cash to the bank for newly-issued shares. This would once again increase the apparent net worth of the banks, though it would not yield immediate loanable funds, nor reduce the GOES backlog of debt service due and coming due in the future.

6.4 Alternative Policy Actions Concerning the Bonds:

If local currency were made available for the purpose, it might be used to put the debt service up to date. (This might be applied to the other GOES bonds overdue; it is not just agrarian reform bonds, though they are the bulk of the problem.) The inflationary impact of doing this would be modest; about one-third of the bonds are in the hands of the public, which would be likely to spend the cash received. (This could be reduced if bondholders were required to apply cash received directly to any bank debts outstanding.)

Another third of the debt service paid would go to the banks; it could be neutralized through existing measures of BCR control over bank reserves. And the remainder of the debt service is owed to the GOES itself, since the Treasury holds some C/ 250 million in bonds and C/ 95 million in interest coupons, which it has received in payment of taxes and performance bonds. That money would not enter circulation -- unless someone forgot to tell the GOES that it was a nominal payment, rather than genuine disposable money, as if the taxes had been paid in cash.

6.5 Recommendations:

I do not recommend any urgent action on the overdue bonds. In the limited time available to address this issue, I did not detect an urgency on the part of bondholders. There is an established market in bonds and interest coupons, and they are applied on taxes, so the GOES in effect redeems them anyhow, though belatedly.

On the other hand, a self-respecting government does not need the precedent of failure to honor its debt service obligations, even if there is little political pressure to pay. Thus as part of a general "saneamiento" of government finances, payment would be very much in order. I recommend that payment therefore be made in conjunction with other measures intended to restore "seriedad" to government finances in general.

If peace is achieved, the "peace dividend" could be used in part in this way. In this case, it would be real resources that the banks could then use to make real new loans. Thus the peace dividend could simultaneously extinguish overdue bond debt service and revitalize the economy by increasing loanable funds at the banks, as well as in the hands of private bondholders.

Chapter Seven

Options for Creating a Rural Land Financing Mechanism for Campesinos

In El Salvador, the land market functions under the great handicap of a lack of long-term financial institutions that can help a would-be small farmer buy land from a willing seller. There does not appear to be a great shortage of land whose owners are willing to sell. However, the owners are unable or unwilling to pay the cost of subdividing the land. They are also reluctant to finance the sale themselves, taking promissory notes over a long period, from many separate buyers.

There were cases a decade ago, in which cooperatives bought farms from landowners, who accepted payment in BFA bonds. Today, most owners seem reluctant to exchange land for anyone's long-term bonds, unless there is also a sizeable cash payment (say, 50%). This is understandable, given the non-performance on existing debts. There are at least three solutions in sight, however. One of them has the great advantage that it does not require legislation, taxpayer subsidy, or other government action other than an internal BCR decision.

7.1 Private Real Estate Subdividers.

First, there are some solvent private real estate firms in El Salvador, that have established a successful record of buying land, dividing it, and selling lots or parcels to low-income families on long-term land contracts. The sales are structured as long-term leases, coupled with conditional sale contracts. Buyers who don't pay could be expelled for non-payment of rent, but those who get behind just sell their interests to another smallholder, who simply assumes the balance of the debt.

These firms generally contract with sellers on the basis that the seller puts up the land, and the firm puts up all expenses and costs, including the investment to lay out the land in lots or parcels. The firms handle all the legal work, all the advertising and sales work, collect all payments, and pay the seller periodically the agreed-upon share of the proceeds. The seller has full access to the books, but need not have any face-to-face contact with the buyers, nor worry about any of their personal or family problems.

As a rule, the realtor tells buyers that although the land price seems high, there is no interest at all on the unpaid balance. (However, the realtor gives a discount of 10% for any payments made at least a year ahead of time.)

7.1.1 Seller Financing That Works.

This approach is basically seller-financed, but it solves the transactions cost and hassle for the seller. It doesn't give the example, a bank may be reluctant to admit that it loaned more money than a farm was worth, and to book the loss. So it prefers to keep the farm as an asset, and rent it out to a client, hoping that in time land prices may rise enough to cover the amount the bank loaned on that security.

7.1.3 The Role of the BCR.

To hold an "extraordinary asset" more than two years, the bank must obtain permission from the BCR, but the BCR has routinely granted such permission in many cases, sometimes for years. The private real estate operators are prepared to divide and sell farms in parcels, at much higher prices per manzana than an entire farm brings. They believe that they could cover the bank's investment, as well as their own profits, but in general the banks have refused to deal with them.

One real estate entrepreneur stated that his firm had indeed divided a farm into parcels for a bank, but indirectly. That is, the bank ordered a delinquent borrower to sell the farm, and the contract specified that the real estate firm paid the seller's share of all receipts directly to the Bank. (Banco Cuzcatlán) The bank thus avoided the cost and delays of foreclosure, but got a price high enough to cover its exposure. The seller avoided the embarrassment of a foreclosure, and also obtained a good price for his land.

Obviously, the banks could also create their own real estate departments and sell the land. The BFA has done such things in the past, or at least has financed the purchase of land by cooperatives that then subdivided it among their members.

One high executive at the BFA stated bluntly in May that he wants to sell farms held by the BFA, but for cash, and as medium to large farms. He showed no interest in turning the foreclosed farm into many small parcels, nor in having to deal with buyers over 10 or 15 years, even though they would presumably be good clients for the BFA.

His attitude may have reflected poor experience in payments by the cooperatives, in the 1970's. However, I believe it would be well worth the BFA's while to enter into contractual arrangements with solvent private real estate firms to carry out these operations, free of political pressures and interference.

7.1.4 Recommendation

The GOES could help restore the land market and provide access to land by campesinos, by ordering the banks to deal with such firms in order to sell farms they have foreclosed on. This would replace their present practice of 1) asking the BCR for permission to postpone a sale, or 2) selling in one large property to another client. In most cases, the selling bank would receive more money, because land prices are much higher in small parcels. And in all cases, the assets would become performing investments for the bank, thus improving their balance sheets before privatization.

7.2 Finata and the Banks as Real Estate Firms.

Second, FINATA and the banks could themselves become real estate firms, laying out parcels and selling them on long terms to campesinos. As indicated, the BFA has been burned in the past, and is probably not interested in trying again.

However, FINATA is already doing a good deal of this, and wants to do more. It finds that potential sellers want a large cash down payment, more than the buyers can put up. Although sellers are willing to take some payment in FINATA bonds, they discount them heavily, which is understandable given the GOES performance on bonds.

Hoped-for external resources have not yet materialized. Thus FINATA is hampered by a misfit between its desire to pay sellers a large down payment and the balance over a few years, and its desire to allow buyers more years to pay, coupled with the lack of a very effective way of getting buyers to pay on time or transfer the land to someone who will.

FINATA could succeed in the land sale business, if it persuaded sellers to accept initial payments similar to buyer down payments, and future installments at the same pace at which buyers pay. It already has a substantial program going, on the basis of sales begun last year, and has a significant list of would-be buyers, many of whom have made cash down payments to FINATA on the order of 5% or more of the price at which FINATA hopes to be able to sell land to them.

7.3 The Interest Rate Problem.

A third option is to find another entity that will cover the cash flow problem created when FINATA or any other real estate transfer program offers to pay land sellers more cash, faster, than is paid by buyers. It is not likely that anyone in El Salvador today will volunteer to finance that cash flow, first because FINATA and the banks cannot offer a credible guarantee of timely performance in repaying such a debt. More importantly, the prevailing interest rates in El Salvador are negative in real terms, and neither campesinos nor politicians want to accept positive real interest rates -- while lenders insist on them.

In short, we have a land program trying to deal with a market in which buyers dream of a Tooth Fairy that will fill a very large cavity.

7.3.1 Are External Resources a Solution?

FINATA has sought to borrow abroad; the potential lenders want repayment in dollars, which is just a more courteous way of demanding a positive real rate of interest. FINATA has not yet found a credible way to finance the foreign exchange rate risk. This is a simple variant on the general problem that politicians and campesinos want low nominal interest rates, while sellers and financiers want a positive real rate of interest.

7.3.2 How do the Private Real Estate Brokers Do It?

In the first option, the private real estate firm, the seller simply marks up the land price by enough to provide an acceptable total real price for the land, despite inflation. FINATA, however, is attempting to buy land and resell it at prices similar to those which would apply for cash sales. At those prices, and given the low interest rates FINATA can offer, and some doubt (based on experience with other GOES bonds) as to whether FINATA bonds will be paid on time, FINATA has had problems persuading sellers to agree to sell unless a very large part of the price is paid in cash -- far beyond the fraction buyers are willing or able to put up.[55]

The private sector real estate firms accept this desire to believe in the Tooth Fairy. They raise the selling price for the land, and then agree to nominal interest rates, or in some cases, the real estate firm tells buyers that the sale is with no interest at all. However, discounts -- typically, of 10% -- are given for any payments made a year or more ahead of schedule. In effect, including anticipated inflation in the selling price loads the land payments heavily toward the early years, in effect increasing the down payment. This is by no means bad; it may be the only way to get an effective land market going despite the insistence of politicians and citizens on seeking unrealistically low interest rates.)

7.3.3 The Result of Interest Rate Fiction: Smaller Parcels.

In a market in which land prices include anticipated inflation, buyers will be forced to buy even smaller parcels. In a real land market, with positive real rates of interest, a campesino might hope to buy four manzanas, on a 10% down payment and financed at six per cent interest plus an index equal to the increase in the Consumer Price Index. But when politicians insist that this is "abusive," he finds himself forced to buy for one-third down, at a much higher price per manzana, so he is forced to buy just two manzanas to start. With luck, he will buy two manzanas and rent two more somewhere near.

Neither sellers nor buyers are stupid, in El Salvador nor anywhere else. Inflation has been around for well over a decade. If indexing is illegal, sellers defend themselves by insisting on higher prices and larger down payments, and buyers have to go for smaller

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[55] FINATA is to be commended, however, for escaping the trap into which many politicians and government agencies fall, of not demanding any down payment at all. This is a virtual guarantee of non-payment of future quotas as well; it makes the transaction look like a gift of the land. And of course, with no payments coming in, the agency is unable to finance any more land sales. FINATA correctly tells campesino organizations and politicians that after all the campesinos who can make down payments have been served, any remaining land could be offered to those who cannot make a down payment.

parcels. After a few years, inflation will have reduced the payments to nominal burdens, and a successful small farmer will look around for another two manzanas to add to the first parcel. Unfortunately, they are not likely to be adjacent, so the effort to preserve illusions about interest rates has worsened the fragmentation which economists see as a source of inefficiency and wasteful transport costs.

7.3.4 A Role for Non-Governmental Organizations?

Non-governmental organizations might just be able to carry out an effective land market mechanism to transfer land to campesinos, but we have not yet identified any that could do the job alone. Their strengths may lie in lowering transactions costs and ensuring that at least some of the poorest campesinos have a chance at acquiring land, despite their lack of funds for down payments, or their need for extra assistance in farming methods and equipment in order to make payments.

There are many non-governmental organizations with good programs in El Salvador, some with external ties and others entirely local. Since any viable land market mechanism will require a down payment and market prices for land (including a price high enough to cover expected inflation in excess of stated interest rates), an NGO could identify worthy applicants and channel donations to help them buy land on market terms.

This would have the enormous advantage of enabling the land market itself to function on viable, replicable terms -- payments by the first buyers help finance the acquisition of more land to sell to more campesinos. Yet it would ease the anguish of a situation in which some (but not all) campesinos really cannot come up with the required down payment and yet are potentially excellent small producers.

Some NGO's are also very good at training, and at helping smallholders become viable producers in a competitive market. They can be valuable complements to any land market program, public or private. The private sector realtors mentioned above look for local NGO's to help organize social services and attend other needs of their buyers. The realtor makes modest donations to such groups, precisely because they help his buyers raise their incomes and deal with personal problems, which makes it easier for them to make land payments also.[56]

7.3.5 Campesino Organizations as Intermediaries.

Several leaders of campesino organizations have urged that their organizations themselves could function as NGO land market financing mechanisms. That is, "someone" should fund them, to allow them to buy land from present owners and resell the land to their members or other campesinos.

Something like this has been done in El Salvador, by several campesino organizations. In general, the organizations located a willing seller, negotiated a price, and persuaded the BFA or the GOES to finance the transaction. Far more operations were proposed than were carried out; the BFA often stated that it thought the campesinos agreed to prices too high to be repaid. It may have been right; actual repayment records were fairly poor, partly perhaps because the BFA did not have an effective enforcement method, or did not choose to use it. The BFA is unwilling to finance more transactions of this sort.

In a variant of sort, I proposed two years ago that the campesino organizations could provide their own Guarantee Fund for land transactions. Essentially, the campesino would pay an extra 2% a year Guarantee fee to FINATA, and each year FINATA would pay the campesino organization whatever amount this brought in -- less any unpaid quotas owed by members guaranteed by that organization.

In other words, the organization would have a substantial income, provided it also saw to it that its members made their payments. After initial enthusiasm, the leaders of all organizations consulted withdrew their interest. They stated that they feared that other organizations would "steal" their members, if the organization became in

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[56] For example, one realtor "never" donates cash outright to buy something needed in the community, but is "always" ready to donate a boom box or some other prize to be raffled off in the community, by a local NGO, so that the residents themselves can solve the problem. This way the community sets priorities, and the realtor is a "good guy" who helps achieve goals.

effect a bill collector for FINATA, so they would lose money and members both. They had no suggestions as to how else FINATA could achieve low-cost effective full repayment of land payments.

Again in 1990, the organizations volunteering to become land market intermediaries were unsure as to how they could effectively achieve full, punctual repayment of debts assumed by their buyers. One method that has proved successful elsewhere is described below; perhaps some form of Effective Solidarity is the answer, but it needs exploration in depth with the campesino organizations.

7.4 A Rediscount "Window" for Land Market Transactions.

If external resources are unavailable a negative real rates of interest, or if the exchange rate risk cannot be assumed by a credible risk-bearer, then we must consider the domestic market.

In the United States, many Savings & Loans and other mortgage lenders "package" home mortgage loans and resell them to insurance companies, pension funds, and other long-term investors. Alas, such investors are extremely scarce in El Salvador, and they have no trouble finding investments. A key part of the problem, of course, is that the mortgages in El Salvador would probably carry an interest rate below the expected rate of inflation. They might well also be burdened with real doubt as to how many of the borrowers would pay, and as to whether the originating lender would make good on delinquent payments.[57]

If the private sector cannot help, what about the public sector? Could El Salvador's support a generous government-financed rediscount mechanism? The answer, clearly, for now, is negative.

7.4.1 What about a Rediscount Window at the BCR?

In the past, the BCR has funded various programs this way, and the techniques are familiar to Salvadoran bankers. A bank, FINATA

[57] As mentioned above, ISTA has apparently never made good on its voluminous guarantees extended to Salvadoran banks, on behalf of land reform cooperative borrowers.

or any other institution would sell farm land and assemble packets of the resulting mortgage loans. It would then "rediscount" these loans at the Central Bank. The buyer would continue to deal with the original bank, which earn a small fee for collecting payments for the BCR.

The credit risk normally stays with the originating bank; that is, it must repay the BCR even if the land buyer failed to make a payment. And the BCR, unlike an insurance company, would be able to at least try to collect, by debiting the reserve account of the originating bank.

7.4.2 What About a Guarantee Fund?

Again, politicians often seek a "Tooth Fairy" in the form of a Guarantee Fund separate from the BCR or the original bank, that will make any payments that are missed by the original borrower. We do not recommend a Guarantee Fund for a land market financing mechanism.

Guarantee Funds tend to be drawn down rather fast, especially if it is easier for the bank and the BCR to draw them than to go after the original borrower and collect. In most cases, it would be more appropriate to identify the possible "legitimate" causes of non-payment and create insurance to cover them -- while providing effective means for collecting from borrowers who could pay, but just don't want to. Thus, in various proposals related to ISTA and FINATA programs, we have always recommended inclusion of "insurance" that forgives debts of individuals who die or suffer major disability. For borderline cases of personal hardships, local NGO's are often the best mechanisms for helping, far better than the a generous (or sloppy) collection policy by a bank. And the NGO can often help an overdue but worthy family come up with their payment. But we also recommend changing collection methods so that able-bodied borrowers must actually pay, and on time.

7.5 What Collection Methods Do Work?

There are at least two methods that appear workable in El Salvador. The land sale may be structured as a rental rather than a sale, or it may be part of an effective Solidarity scheme. The first plan is already in use in El Salvador, for urban and suburban housing lots, and the second has been used successfully in the Dominican Republic for over five years, for agricultural production loans.[58]

7.5.1 The Rental-with-Option to Buy.

In this method, the seller structures the sale as a long-term lease, coupled with an irrevocable option that allows the "tenant" to "buy" the farm by making all payments on time. The buyer cannot be evicted and the seller cannot refuse to renew the lease, as long as all payments are made on time. When the last "rent" is paid, typically after eight to twelve years, the buyer receives full freehold title.

With a private sector seller, this is credible -- more so when the seller can point to a history of satisfied buyers who have in fact completed their payments and have in fact received their freehold, registered titles.

Unfortunately, for FINATA and ISTA, campesinos know that politicians often seek to keep campesinos in dependency and resist actually delivering the freehold titles. Politicians in El Salvador have in the past also sought to prohibit campesinos from reselling the land they receive, sometimes for 30 years, even after the land debt is paid. Thus government agencies understandably find that campesinos insist on buying land with a title, subject to a mortgage lien. The trouble with this from a financial point of view, is that foreclosing on a mortgage is expensive and time-consuming, and government agencies tend to refinance forever rather than do it.

Even countries with legislation protecting tenants always provide that a tenant who fails to pay the rent, must leave. Thus the land sale structured as a long-term lease with an irrevocable option to buy, is enforceable and buyers either make the payments or sell their interest to someone else who will. The seller rarely has to evict a buyer; the rules of the game are clear, and politics does not enter.

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[58] See, for instance, Strasma, John. "Peer Intervention" as an Effective, Low Transactions Cost Method of Collecting Agricultural Loans in Developing Countries. Madison: University of Wisconsin Department of Agricultural Economics Staff Paper, July 1990.

7.5.2 Solidarity Groups that Work.

Secondly, it may be possible to set up Solidarity Groups that actually make all payments on time, and that have their own effective ways to collect from delinquents. The Dominican version of these is now more than five years old, and seems to work quite well. Basically, the group is the official borrower, and each member accepts a contract under which if the group is forced to make a payment for a member who becomes delinquent, he has agreed in advance that the group may take over his parcel. In the Dominican version, the group rents such parcels to someone, and uses the rent to repay itself for the money it paid on behalf of the delinquent borrower. When the debt is fully paid, the renter leaves and the original parcel holder is allowed to return to his parcel.

The Solidarity method works, in the Dominican case, because it is quick and certain, and because the groups tend to have only a few delinquent borrowers in any given harvest. It is also much more acceptable than traditional private lending, because unlike foreclosure, the borrower merely loses the use of his land for a time, but does not lose the land.

7.6 Recommendations

7.6.1 Use Existing Private Firms to Liquidate Foreclosed Farms.

Because it can take effect at once, with a simple Directive from the BCR, I recommend that the GOES first utilize existing firms in the private sector to sell farms now in hands of the banks, in parcels, to individual campesinos. This will be in the interest of the Banks, the campesinos, and the country. These sales would take the legal form of long-term leases with option to buy, irrevocable except for non-payment of rent, and leading to registered, freehold title.

7.6.2 Allow FINATA to Compete with Similar Methods.

Second, I recommend that FINATA and any other interested banks, be authorized to compete effectively in the land market, on similar terms. That is, they should be authorized to sell land on conditional sale contracts or land contracts, legally rentals for purposes of enforcing payment, but leading unambiguously to clear freehold title, with no restrictions on resale, the moment the final payment is made.

If, as seems likely, FINATA and the banks are not allowed to charge an interest rate that is higher than expected inflation, then they should be allowed the same freedom to adjust other terms of the sale, that are available to the private sector. They could, for instance, raise prices per manzana to a level such that the seller is willing to accept the same percentage down payment as the campesino is willing to pay, and the same nominal interest rate that is politically acceptable, plus a spread of 4 to 5% for FINATA's administrative costs and 1 to 2% a year for life insurance.

To deal with fears that freehold titles would not be granted even after payments were completed, FINATA could have the titles drawn up and transfer them to a neutral Trustee, who would register the title and turn it over to the campesino as soon as either FINATA or the buyer provided proof that all agreed-upon payments had been made.

7.3 Create Effective Solidarity Contracts for ISTA Land Sales.

In selling land to its own beneficiaries, ISTA also has to deal with delinquents. As an alternative to foreclosure, I recommend that small groups of buyers be formed, to enter into contracts with ISTA and each other, providing for peer intervention on the Dominican model in the event of non-payment of a quota. That is, groups of 30 or so beneficiaries would sign agreements with each other and ISTA, under which any beneficiary that missed a payment would have to leave his parcel temporarily. The rest of the group would make his payment, but would recover the money immediately by renting his parcel (for cash in advance, as land is normally rented in El Salvador), for the coming season.

Since land payments including capitalized overdue credits are not to exceed going rental values, under ISTA's plan, this method will ensure that ISTA will get payments on time and no beneficiary would be forced to leave his parcel for more than one crop, if he only failed to meet his land payment.

If, as is likely, the BFA also insists on solidarity protection for production credit, then the intervention might have to be for more than one crop in order to cover both land payment and production credit payments. However, in this method the original beneficiary is never expelled for good -- he just loses the use of the land while his peers recover the payments they made for him.

7.4 <u>Encourage NGO participation in land market projects</u>.

NGO's can help campesinos learn about available parcels, and can help with training to make them more productive small farmers. They have both modest resources and the ability to sort out the truly worthy, to assist the very best potential young farmers to get together a down payment or to make an annual payment that is overdue through no fault of the farmer. No financial agency can ever screen such cases as well as an NGO that is using its own money to help what it deems truly worthy cases; the result is that the land program remains solvent, and the NGO helps ensure that the worthy but unfortunate are not kicked out of it.

7.5 <u>Move Toward Monetary and Fiscal Equilibrium</u>.

This recommendation, which would have positive effects far beyond the land market, will of course take longer to carry out. The present nominal interest rates will be quite adequate for an effective land market if inflation ends. Rediscount windows could be opened for land mortgage loans, or banks could advance real cash as loans to land sellers as soon as they entered into contracts with parcellers, etc.

I do not have specific recommendations for accomplishing this goal, except that reassessment of real estate values could help the wealth tax reflect actual market values.

This alone would not suffice to fill the fiscal cavity at present, and it would be unjust if not accompanied by other means to correct other major forms of tax evasion. Nonetheless, I do recommend it as a longer-term step, part of a general restoration of equity and efficiency in El Salvador's fiscal mechanisms.

Chapter Eight

SUMMARY OF FINDINGS AND RECOMMENDATIONS

8.1 Overview:

The 1980 land reforms in El Salvador are ten years old; there are now about 77,000 campesinos involved. With their families, they number about 462,000 persons, almost ten percent of the national population and a larger fraction of the rural labor force.

The land distribution was uneven; ISTA beneficiaries (former resident workers on large farms) averaged over 10 manzanas apiece, while many thousands of landless laborers living near by got no benefit from the land reform. (The national average ratio of land per person in the agricultural labor force is about 6 manzanas.)

FINATA beneficiaries (former tenants) average 2.2 manzanas, and of worse land at that. In both agency programs, there are enormous variations from farm to farm, in the man-land ratio. Still, it is astounding that on average the value of land assigned averaged C/ 23,000 (ISTA) and C/ 2,600 (FINATA).

ISTA has tried to oblige beneficiaries to work the land collectively; FINATA's beneficiaries mostly work individually. Despite the difference in land quality, FINATA beneficiaries achieve yields per manzana similar to those of ISTA, and both are close to national averages for the rest of the agricultural sector. Some ISTA cooperatives have not cultivated large parts of their assigned land recently, for various reasons discussed in Chapter One.

Land reform beneficiary debts are a serious but not an insurmountable problem. The "bonding out" of coop debts at the banks makes sense, though it will not solve all the problems of either the banks or the cooperatives. The proposed reforms of Phase I cooperative organization and land tenure appear sound, but more attention is needed to the <u>process</u> of achieving consensus among beneficiaries. This may require dividing cooperatives, accepting new members, and repeated straw votes until consensus is achieved in each unit.

Allocating land and production debts among beneficiaries when cooperatives are divided is within ISTA's technical competence. However, the technicians should make an initial proposal and ISTA should be open to modifying it after open discussion with the campesinos, who know that particular land best.

The GOES is in arrears in the service of its own debts to the holders of bonds issued in compensation for expropriated land. It is also in arrears on other GOES bond issues. Many of the bonds are in the hands of the banks, which are in the public sector, and many other bonds and overdue interest coupons are in the Treasury, having been used to pay taxes due. There does not appear to be a major crisis concerning the arrears on the bonds, and it is likely that in time almost all of them will be used in tax payments--forcing the government to pay them after all.

Finally, under the present economic stringency, the options available to create a land market financing mechanism for campesinos hinge mainly on the ability of an intermediary to persuade land sellers to accept payment at the rate at which buyers can make payment. The most promising option involves existing real estate firms that have demonstrated success at just that.

Official institutions, such as FINATA, suffer constant decapitalization because their loan delinquencies are high and interest rates are less than inflation. Even if they had 100% collection and an interest rate equal to inflation, they also suffer a major cash flow problem because they agreed to pay sellers a higher down payment and the balance over fewer years than the terms FINATA has promised to would-be land buyers.

The loan delinquency problem could be solved with effective collection methods, such as are used by private realtors, or by the type of peer intervention used in Solidarity group loans to rice growers in the Dominican Republic.[59]

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[59] See Ch. 5 and 7, above.

An external loan could solve the cash flow problem, provided repayment were stretched out over at least as many years as are given campesino land buyers. However, if the external lender demands repayment in hard currency, FINATA also needs someone who will absorb the exchange-rate risk. At present, it appears that repaying external loans would require more colones than FINATA would collect, even with interest and 100% loan recovery.

If a donor or "soft lender" is willing to subsidize the operation, then it should be feasible for FINATA to become an intermediary as well.

8.2 New Tenure Forms for ISTA Cooperatives

This plan is well-conceived as announced by ISTA in March, 1990. However, the rule that a 51% majority vote decides the future of all members of each existing cooperative is a recipe for conflict. More discussion and new ballots should be taken until genuine (at least 80%) consensus is achieved. ISTA should also encourage large cooperatives (over 30 families) to split into smaller, more compact units, whose members can more readily agree.

Consensus could be aided by a series of non-binding straw votes to narrow ISTA's four options to two, by eliminating those tenure forms that find no support among members of a given cooperative. Where there is idle land, or more land than the national average, new members should be admitted before the final vote is taken. And if the present members reject that, then part of the land should be hived off for distribution to others.

Scale economies in coffee and sugar do not require farms as large as some of the present cooperatives. Nor do they require that one cooperative produce both, as many do now.

Nor is there usually an economic justification for cooperatives that have several separate pieces of land, just because they were once owned by the same large landowner. Consensus on tenure may be easier if such units are divided into natural and logical enterprises of more compact dimensions, with a high degree of consensus among the members of each as to how they want to organize their production and tenure.

The debt issue should be clarified early in the discussion. ISTA should issue a proposed allocation of debts early on, for each cooperative to be reorganized. Much land debt can be allocated to each manzana of land according to its quality, access and infrastructure; capital-intensive enterprises such as sugar mills or coffee processors carry their own share of the total debt.

Some current and overdue production debts are tied to specific crops or enterprises, they can be allocated; the rest should be prorated with the land. Great precision is not needed. Members know the farm well, and will point out any gross inequity in the proposal, so ISTA can correct the final proposal.[60]

8.3 <u>Reduction and Refinancing of Reform Cooperative Bank Debts</u>

ISTA proposes to consolidate land debts with overdue or refinanced production debts of the Phase I beneficiaries, before reorganizing the cooperatives. As a safeguard, ISTA would limit future payments by beneficiaries for the land, to not more than the current rental value of such land in that area. However, a few debts of the cooperatives should be written off completely.

The C/ 60 million in initial loans, held by ISTA, can and should be written off. They haven't accrued interest since 1982, and are not real assets. Likewise, ISTA should make good on its guarantee of bank loans made to cooperatives that have been abandoned; by PERA figures, this would only take about C/ 800,000. In practice, it will be done with ISTA bonds, as part of the general "bonding out."

In a few other cases, overdue bank debts of the cooperatives might be written off; these would be cases close to abandonment, such as

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[60] ISTA leadership is aware that its own staff, as well as campesino organizations and coop leaders may be biased. Some will oppose tenure changes that end their administrative jobs, let alone a tenure form (individual parcels) that doesn't need a powerful Junta Directiva. However, the more alert and progressive leaders will realize that the future demands strong organizations of smallholders, and well-run service cooperatives, and will seek to organize and lead those.

farms hit by combat, flood or the like. However, many unpaid debts reflect mismanagement, theft, or expensive social services provided to members as expenses of the cooperatives. In effect, they are part of the cost of bringing the land to this moment of decision for the future.

The current payoff value of the ISTA cooperative land debts is under C/900 million, while the overdue production and investment debts of the coops to the banks come to about C/ 282 million. Thus there is a total of some C/ 1,180 million to be refinanced, as part of the reorganization of the ISTA cooperatives.

In most cases, the overdue and refinanced bank debts should simply be added to the land debt of each cooperative, before it is reorganized. If the resulting annual land payment exceeds the current annual rental value of that land in that area, then ISTA might well write off certain loans, selectively, in order to adjust the total land payments to the annual rental value.

In other cases, the price paid the former owner (based on his tax declaration of 1976-77) was so low that the beneficiaries can perfectly well afford to repay all overdues along with the land debt, and still be well ahead of the rental value of the land.

There is a great demand to rent farm land in El Salvador, and ISTA should have little trouble finding campesinos eager to enter any cooperative about to be reorganized, to replace any who might leave solely in protest over having to repay -- over many years -- production loans that were not paid on time in years past.

8.4 "Bonding Out" of Cooperative Debts to the Banks.

Commercial bank loans to the agrarian reform cooperatives are less than 4% of the bank portfolios. Yet loans to the land reform cooperatives are often stressed in public discussion of the banks.[61] Their repayment record is no worse than that of other debtors; they are not the main cause of bank insolvency. For that reason, using GOES

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[61] For instance, by Mario Rosenthal, in the El Salvador News-Gazette of May 21-27, 1990, p.1, who is reflecting accurately what the local press often says, imputing much of the bank insolvency to the debts of the land reform cooperatives.

bonds to pay off the overdue and refinanced loans is a good idea. It will remove that smoke screen and may help the GOES address the real problems of the banks. Because those debts are such a small part of the total problem, it will cost little to Salvadoran taxpayers.[62]

Bonding out will also help some of the new individual and self-managed farms get off to a clean start. Packaging their overdue debts together with their land debts, as long-term obligations, reduces their annual debt service and makes it appear that they have nothing overdue. It may or may not enable them to get new loans, since the banks are well aware of the true credit record of that group.

8.5 Adjustments of the Consolidated Debts during Reorganization.

ISTA plans to limit the maximum payments required of any cooperative to the going rate for land rental in the area. However, several other adjustments would enhance the sense of "fairness" in the debt consolidation. For example, ISTA should offer discounts for pre-payment of the consolidated debts, and credit life insurance for individual parcel buyers, for reasons discussed in Chapter 4.[63]

ISTA should also grant credit for land payments already made by a few cooperatives, just as is done for pre-payment of future obligations. And ISTA should adjust the terms for debt assumed by new members coming into the cooperative in 1990-1991, to recognize the "sweat equity" built up by the members already in place.

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[62] This does not mean an endorsement of the idea of bonding out all bad debts in the bank portfolios, which goes beyond my terms of reference. That scheme would appear to give huge subsidies at Salvadoran taxpayer expense. Worse, the subsidy would be greatest for the banks that were mis-managed most severely, and for the borrowers who got away with the largest unpaid loans. The draft proposal compounds past errors by leaving each bank "managing" the loans it has already failed to collect. Usually, when banks are intervened, another entity buys the bad loans and has clear incentives to collect them.

I do support "bonding out" the loans to reform cooperatives because they have taken the blame for the entire problem, and because this will do much to facilitate the successful launching of the new individual and cooperative farm enterprises in Phase I. That in turn will revitalize part of the economy, and hence help support the future cleaning up of the whole banking sector.

[63] In section 4.4, above.

8.6 Future Land Transactions

At the same time, after reorganization, beneficiaries will have to understand that loans really do have to be repaid. After the reorganization, they will own the land -- and if they borrow, will have to offer genuine collateral. So those who fail to repay, after the banks and the cooperatives are reorganized, will sometimes be forced to rent or sell their land to other campesinos who can and will repay the debts.[64]

Many informal transactions could be eliminated and campesino welfare improved, by making it as easy to transfer land formally as to do it informally. The law should allow individual campesinos to sell their land or their shares in cooperatives, without requiring permission from any bureaucrat. Some campesinos will inevitably suffer accidents, want to retire or to move elsewhere, or will simply be unsuccessful as farmers. They should not be forced to justify their decision to any functionary. Rather, they should be free to sell their land directly to other campesinos.[65]

The proposed Land Banks should facilitate transactions among campesinos as eagerly as they will facilitate the division of larger farms into parcels.

Experience in El Salvador and elsewhere shows that when farmers are forbidden to resell their parcels, many are forced to do so anyhow -- but they receive lower prices than if it were legal. Limits and bureaucratic obstacles are unjust to campesinos and tend to create de facto situations in which land tenure in fact bears little resemblance to the distribution of land in official records.

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[64] The rental option is the essence of an effective system used in the Dominican Republic. See John Strasma, "Peer Intervention" as an Effective, Low Transactions Cost Method of Collecting Agricultural Loans in Developing Countries. Madison: University of Wisconsin Department of Agricultural Economics Staff Paper, July 1990.

[65] The usual definition of a "campesino" is a person who lives by farming and owns less than 7 hectares of land including the parcel he is about to buy. Enforcement can be part of the normal process of registering title transfers.

8.7 A Proposed General Bonding Out of Bad Debts at the Banks.

The preceding chapters indicate sympathy for the "bonding out" of land reform beneficiary debts at the banks. This is especially true because those overdue debts are only a small fraction of the total overdue debts in bank portfolios -- 4.3% as of late 1989.

However, it is not obvious that a general "bonding out" is justified (See Chapter 5). At 14% interest, the current proposal, the C/ 3 billion in bonds would bear annual interest of C/ 420 million, to be paid by the Salvadoran taxpayer for the sole purpose of "bailing out" the banks.

Worse, the proposal floated in early 1990 would leave the management of the non-performing loans right in the hands of the same bank managements that made the bad loans and then failed to collect them. Since the bonds would be issued in proportion to the bad debts on hand, the greatest taxpayer subsidy would go directly to the worst bank managements. If the latter were then free to just write off the bad debts, the greatest subsidy would also go to the greatest defaulters.

While the "bonding out" would improve the apparent balance sheets of the banks, the GOES is not current in the service of the debts outstanding now. Thus it is not clear how much potential buyers would be willing to pay for a huge stack of bonds that might or might not be paid when due.

There are several alternatives, the most obvious of which is to identify worthy non-paying borrowers and use bonds to pay off their overdue debts. There are precedents in agriculture (FFRAP) and in Northern Ireland, where the Government pays compensation to companies whose plants are destroyed by terrorist acts.

In effect, the "bonding out" of land reform beneficiary debts assumes that most of them are worthy, but victims of either the conflict or of the coercion to operate collectively, which in some cases led to theft, inefficiency, or poor productivity.

8.8 A Guarantee Scheme for Future Credit.

Chapter 6 also analyses some proposals to guarantee future lending. Some proposals contemplated the use of local currency already sterilized, assuming that the Guarantee would never be needed, and hence the money would not enter circulation. Chapter 6 analyzes the risks of natural disaster, violence, personal disaster, and incompetence and moral hazards. Essentially, unless effective insurance is provided, with premiums paid by borrowers in addition to interest rates, many of these hazards will occur. And if there is no mechanism for effective collection of overdue debts, the moral hazards (sometimes disguised as populist political measures) will also occur, even when the borrower is able to repay.

8.9 GOES Obligations to Holders of Land Reform Bonds

The GOES is itself overdue in service of both interest and principal on the land reform bonds given former landowners, as discussed in Chapter 6. It is also overdue in the service of various other bond issues, for public works and the like. There has been relatively little protest; it appears that the bulk of the bonds are held by banks -- also owned by the GOES -- or have been used in payment of taxes, and are therefore held by the GOES itself.

The total bond issue for ISTA's land compensation will come to about C/ 850 million when pending cases are resolved. It appears that in early 1990, some C/ 274 million were still in the hands of the public, and a similar amount in the (state-owned) banks, while close to C/ 250 million had been used in payment of taxes or performance bonds, and so were already in the hands of the Government. The figures for the banks and the public will rise when the last cases are settled.

These unpaid obligations are similar to the floating debt which the GOES owes suppliers and other creditors; resolution would be a constructive step that might cost the GOES very little, since it is the actual holder of so much of the debt already. If, as is likely, the country's fiscal condition does not allow payment with current real resources, at least the GOES could issue new bonds, at higher interest rates, for payment in the future, for the amounts now overdue, and then attempt to stay current on debt service in the future. This was already done for the banks; they are allowed to exchange ISTA 6% bonds for GOES 12% bonds, which also mature more quickly.

In any event, the public is aware of the fact that certain taxes can be paid with bonds at face value, and that interest coupons that have reached their payment date can be used to pay almost any tax. This legal provision has been honored by the Treasury, so in effect the GOES will actually make good on the bonds and interest, though belatedly. Perhaps it is for this reason that there is seldom much angry protest over the GOES delinquency in paying interest due.

Even so, if funds can be found, the GOES ought to pay the land reform bond arrears, as part of a general cleaning up of delinquent credits. This would itself improve the liquidity of the banks, because they hold a large share of the total bonds outstanding. Thus clearing the arrears could also help the GOES privatize the banks.

8.10 Options for a Rural Land Financing Mechanism for Campesinos

The principal options for creating a rural land financing mechanism for campesinos are three: Use existing private sector firms, use the existing FINATA program, and establish a new Rediscount facility for FINATA and any other intermediary that parcels and sells land to campesinos.

The existing private sector firms have developed an effective way to transfer urban and suburban lots to low-income families; they sell on eight to twelve-year terms, in partnership with the former landowner. The owner puts up the land, the company covers all costs, including the infrastructure, legal expenses, and all costs of selling and collecting. Legally, the transactions are set up as long-term rentals with an option to buy, which is exercised by making the final payment. Buyers then get registered freehold titles to their lots, without further charge--the costs are included in the land price.

One of these companies has successfully divided one farm into parcels already, for a landowner under pressure from his bank. This method would have the enormous advantage of requiring no taxpayer subsidy; landowners and the company finance the entire process, and it works.

A second option would build on FINATA's existing program, which has a significant number of would-be buyers who have already made down payments, and a significant number of would-be land sellers who are merely awaiting FINATA's promised 50% cash down, with the balance to be paid in FINATA bonds. Unfortunately, there is a mis-match between the terms demanded by sellers and the terms required of buyers. FINATA is not allowed to charge interest rates high enough to make sellers willing to accept down payments of 10%, nor is it willing to raise land prices enough to make sellers willing to accept higher prices in lieu of positive real rates of interest.

FINATA has sought external funding for the cash flow problem, but a potential funder has insisted on repayment in dollars. In effect, the problem remains that FINATA cannot sell the land in dollars, nor can it index the land price to ensure that payments it receives will suffice to repay the external loan. Worse, at least some versions of the external funding were still mismatched, in that the loan would have to be repaid before the campesinos paid for the land.

FINATA is a viable mechanism, provided it is allowed to raise interest rates, or to raise land prices high enough that its actual receipts are sufficient to cover inflation and/or devaluation. To be truly viable, FINATA must also implement a truly effective method of collecting all land payments when due. Its recovery record is already better by far than ISTA's over the last decade, but it does not yet have an effective method of ensuring that actual payments are at least as good as those used in its cash flow projections.

Without these reforms, FINATA will only be viable if there is a substantial fiscal or external subsidy.

The third option is to create a Rediscount "Window" at the BCR or elsewhere, that would buy packets of land mortgage loans from FINATA or another parceller, thus replenishing the capital originally paid to the land seller. If the BCR were to lend at a nominal interest rate lower than the rate of expected inflation, it would bear the loss due to inflation, rather than the original land market institution.

A fourth option would be to allow campesino organizations to function as intermediaries, buying land and reselling it to their members. Past experience in El Salvador showed a poor repayment record, and the organizations do not have capital of their own which they would be willing to use in this way. Thus unless another source of funds appears, willing to absorb losses due to non-payment as well as losses due to inflation exceeding the interest rate, this option is not viable.

Unfortunately, the country's monetary and fiscal situation does not appear able to fund a new rediscount mechanism as an indirect subsidy to land buyers, at this time, whether through FINATA or any other intermediary.

8.11 Recommendations

1) Proceed with the ISTA land tenure adjustments, subject to a rule that campesino decisions must be qualified majorities of 80% or more. Early non-binding straw votes should eliminate unpopular options and focus the debate on the issues central to each farm.

2) Beneficiaries should be asked to think explicitly about whether their present boundaries are optimal. If the cooperative already has a title, it could perfectly well split into two or more farms, just as a private owner could. Otherwise, ISTA could make the division if that is what the campesinos asked for. If a cooperative decides against going to individual parcels, it is important that the cooperative unit itself be compact, so members know each other and know what is going on, and have less need for expensive, sophisticated managers.

3) Adjust the land-beneficiary ratio where needed. Some cooperatives have land they have not farmed, and many have more land per member than the national average of land per farm worker. They should be forced to accept more members or to "hive off" excess land for a separate project, before their own cooperative is reorganized and refinanced.

4) Provide clear voting rules, observers and safeguards. ISTA staff and present cooperative leaders may be biased in favor of preserving their own positions; respected outside observers, secret ballots and public counts will help prevent false accusations that ISTA forced the campesinos to a decision they didn't want.

5) ISTA's Acquisition and Valuation Department should make a tentative allocation of land and other debts to the land and enterprises of each cooperative, early in each case in which ISTA and members begin to analyze their options. The members themselves know the farm well; they will point out inequities in this allocation, which can then be modified during the discussions with ISTA, before final decisions are made.

6) ISTA should forgive the uncollected part of the original "cartera" from 1980, and should use ISTA bonds to pay banks for the production credits overdue at abandoned cooperatives. There is no reason to write off land debts, nor current production debts, unless the banks so desire. In the few cases in which land was overpaid, or huge debts have accumulated, the "annual rental value" ceiling on consolidated debt payments ensures that beneficiaries pay no more than if they were renting the land.

7) While consolidating the debts, ISTA should offer credit for the small amounts a few cooperatives have already paid on the land debt, and provide a discount as an incentive for future pre-payments.

8) ISTA should offer credit life and accidental disability insurance as part of the debt "package" for individual beneficiaries.

9) ISTA should adjust the debt share of old members and new entrants, to reflect fairly the "sweat equity" that the present members have or should have built up.

10) As part of their dialogue, ISTA and the campesinos should agree on effective methods of collecting future land and debt payments on time. One solution would be the formation of effective Solidarity groups that would use peer intervention to rent out the parcel of any member who fell behind in his obligations, until the debts were current again.[66]

[66] See Strasma, 1990.

11) Retrain ISTA functionaries, who in many cases have not kept up with the thinking of ISTA leadership on the options and procedures to follow.

12) The GOES should proceed with the "bonding out" of land reform beneficiary overdue debts to the commercial banks. These are a tiny part (4%) of the solvency problem of the banks, but they loom large to the cooperatives and this step will facilitate the reorganization of the Phase I reform. It will also remove a "smokescreen" that has been used to cover up more serious problems at the banks themselves.

13) Part of future negotiations over local currency programs could well include putting service of land reform bonds back up to date. However, many of the bonds and interest coupons have been used in payment of taxes or are in hands of the banks. Available funds should be used first to pay coupons in hands of the public, but if they are not, the tax payment mechanism will in time collect them all anyhow.

14) The GOES ought to pay the land reform bond arrears, as part of a general cleaning up of delinquent credits. This would itself improve the liquidity of the banks, because they hold a large share of the total bonds outstanding. Thus clearing the arrears could also help the GOES privatize the banks.

15) To create a land market mechanism for campesinos at once, the GOES should order all banks to contract with existing, experienced real estate operators to parcel and sell to campesinos all of the farms held by the banks after foreclosure. This requires only a decision by the BCR, under its existing powers, and can be implemented by its President.

16) FINATA, and perhaps other institutions as well, such as NGO's, should be required to adjust land prices, terms and interest rates so as to "match" seller demands and buyer possibilities, just as the private agencies do.

17) If a Land Bank is to be viable, non-payment must not be regarded as the normal solution to individual borrower problems.

18) Non-Government Organizations should be encouraged to fill that vital role of helping individual campesinos with unexpected problems. They can best judge the worthy but unfortunate, as opposed to the greedy and prevaricator. NGO's can also seek donations or softer terms from land sellers, and can assist worthy campesinos in raising substantial down payments, as well as helping them keep current on land payments.

19) Once the overdue debts are "bonded out" and the cooperatives are reorganized into parcels and smaller, more cohesive enterprises, the GOES should lay down clear rules of the game so that all parties know that future credit, and land debts, must be repaid.

20) Farmers who cannot earn enough to support themselves and repay debts should be required to transfer their parcels to others who can. (Life insurance should be part of all credit, and crop insurance should be created wherever possible--at premiums reflecting the full risks.)

21) For land sales, the best approach appears to be land sales structured as rentals with an option to buy the land by making all of the rental payments as agreed. Eviction is a credible sanction for non-payment, and buyers who are unsuccessful as farmers will sell their interests to others who will assume the remaining debt.

22) For existing land debts, and for existing and future production credit, the most effective method may well be to create genuine, effective Solidarity Groups that make payments for delinquent members. To enter such a Group, and thus to be eligible for a loan or to buy an individual parcel from ISTA, the campesino would agree by written contract that if he/she failed to make a timely payment, the Group would immediately and without legal formalities take over his parcel, and rent out his land to recover that debt. Only when the debt was fully repaid

would the campesino recover his parcel; however, unlike foreclosure with traditional loans, he or she would eventually get it back.

23) FINATA could attend at least some of its backlog of would-be land buyers, by improving further its recovery of payments already due it by beneficiaries under Phase III of the land reform.

8.12 <u>Conclusions</u>

A fully-functional agricultural credit sector will not be created until the national economy achieves a measure of equilibrium. That clearly requires civil peace. Nonetheless, much can be done even now, to create new, healthy customs and traditions in place of the general breakdown of lending and farm finance over the last decade.

Though existing loans are still made at negative expected real rates of interest, there is no need to tolerate abysmal rates of loan repayment. After tenure reform, beneficiaries will no longer tend to vote expensive social programs charged to cooperative overhead. With the clear incentives of individual parcels or well-defined, transferrable property rights, they will also be much more productive.

Land bank transactions can be made now through private real estate firms, with 100% collection of land payments, restoring the confidence of potential land sellers. If FINATA improves the collection rate on its existing land debt portfolio, it will be able to begin to buy land and serve some of the backlog of would-be new land buyers.

El Salvador needs to create a productive agricultural sector in which transactions costs are low and loan writeoffs are negligible. A land market will function quite well, and so will formal lenders, and campesinos who are productive will be able to get, and keep, the land.

Agradecimientos

Many Salvadoran officials and experts assisted greatly in gathering material for this study. Among them, I am especially grateful to:

Ing. Antonio Cabrales, Ministro de Agricultura y Ganadería.

Dr. Roberto Orellana, Presidente, Banco Central de Reserva.

Lic. Carlos Pocasangre, Director, Unidad Técnica para el Financiamiento de la Reforma Agraria, Banco Central de Reserva de El Salvador.

Agrónomo Román Francisco Aparico Rivas, Presidente, Instituto Salvadoreño de Transformación Agraria (ISTA).

Sr. Roberto Molina y Morales, Vice-Presidente, ISTA.

Lic. Raul García-Prieto, Director Presidente, Financiera Nacional de Tierras Agrícolas (FINATA).

Ing. Salvador Urrutia Lousel, Director, Proyecto Planificación de la Reforma Agraria (PERA), Oficina Sectorial de Planificación Agropecuaria (OSPA), Ministerio de Agricultura y Ganadería. and to half a dozen experts and old friends from the PERA staff.

In each of the agencies named, I also received invaluable assistance from professionals and aides to the executives interviewed. Their interest and enthusiasm for solving the financial problems of land reform were most helpful and contagious.

At USAID, Ana Luz Joya de Mena provided invaluable insights as well as data throughout this project, as did Eduardo Hipsley. In addition to Mr. Kenneth Ellis, Mr. Clement Weber, Mr. Michael Wise, Mr. Enrique M. Berrau and Mr. Donnie Harrington, I especially appreciate assistance and insights provided by Dr. Julian C. Heriot (ECON).

From CLUSA, Mr. Paul Prentice and Jose Racimo provided insights and background that was as helpful to this project as CLUSA people always are to the Salvadoran reform process and beneficiaries.

To all, thank you very much, and I sincerely hope this study will be of use in your own efforts on behalf of the Salvadoran campesinos.

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