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USAID/EL SALVADOR
FY 1993 ESF ECONOMIC AND DEMOCRATIC REFORM PROGRAM
CONCEPT PAPER

TABLE OF CONTENTS

PAGE

List of Abbreviations and Acronyms

I. SUMMARY AND CONCLUSIONS 1

II. PROGRAM RATIONALE AND RELATIONSHIP TO MISSION STRATEGY 9

A. Overall Program Rationale 9
1. Promote Improved Economic Performance 9
2. Promote Democracy and Human Rights 9
3. Provide Fiscal Support 10
B. Need for Program Assistance 11
1. ESF Leverage Essential to Support Critical Reforms 11
2. El Salvador's Need for Fast Disbursing Program Assistance 12
3. Impact on U.S. Economy 13
C. Relationship to Mission Strategy 13

III. RECENT ECONOMIC AND SOCIAL PERFORMANCE AND OUTLOOK 15

A. GOES Policy Reform Performance 15

1. Economic Policy Reform Performance 1989-1991 15
2. Performance on FY 92 ESF-Supported Measures in the Economic Area 15
3. Performance on IMF and IBRD Programs 17
4. USG Debt Reduction 22
5. Trade and Investment Framework Agreement 22

B. Economic Performance 23

1. Overview 23
2. The Domestic Economy 23
3. Prices 24
4. Public Sector Finances 25
5. Financial Intermediation 28
6. Balance of Payments 28
7. International Reserves 29
8. Exchange Rate Developments 29
9. External Debt 30

C. Social Development 30

1. Economic Adjustment and the Poor 30
2. Employment Trends 31
3. Urban Poverty Rates 32
4. Selected Social Indicators 32
5. Social and Employment Generation Programs 32
6. GOES Social Spending 36
a. Health 36
b. Education 37

PAGE

IV. RECENT INITIATIVES TO STRENGTHEN DEMOCRACY 38

A. Background 38
B. Progress to Date 39
C. Main Constraints 40
1. Justice Sector Reform 40
2. Electoral Code Reform and Democratic Participation 40
3. Respect for Internationally Recognized Worker Rights 41

V. IMPROVING INTEGRATED FINANCIAL MANAGEMENT 42

A. Introduction 42
B. Background 43
C. Progress to Date 44

VI. PROPOSED FY 1993 ESF PROGRAM 46

A. Program Objectives 46

B. Proposed Conditionality Measures 46

1. Consolidate Sustainable Economic Growth 47
a. Improve Fiscal Performance 47
b. Promote Improved Governance Through Decentralization 49
c. Improve Financial Intermediation 50
d. Promote Exports and Further Deepen Trade Liberalization 51
e. Maintain Adequate Macroeconomic Framework and Structural/Sector Adjustment Policies 52
f. Rationalize Public Education and Health Spending 52
g. Improve Quality of the Environment 52
h. Improve Investment Climate 53
2. Strengthen Democratic Practices, Processes and Procedures 53
a. Improve the Administration of Justice 53
b. Support Fair and Free Elections 54
c. Promote Respect for Worker Rights 55
3. Strengthen Integrated Financial Management and Auditing. 56
a. Increase Accountability for the Use of Public Resources 56
b. Improve Public Sector Cash Management 57

C. Dollar Resources 58
1. Cash Transfer vs. CIP 58
2. Use of Dollars 58

D. Local Currency Resources - Programming Issues 59
1. Background 59
2. FY 1992 Program Update 59
a. The General Assessment 60
b. Programming 60
c. Summary Table FY92 Program 61
3. FY 1993 Program 61
a. Budget Unification 61
b. Programming 62
c. Summary Table FY93 Program 62

PAGE

TABLES IN TEXT

Table 1 El Salvador: Performance under the IMF Stand-by Arrangement as of 6-30-92..... 18

Table 2 El Salvador: Performance under the IMF Stand-by Arrangement as of 9-30-92..... 19

Table 3 El Salvador: Performance under the IMF Stand-by Arrangement as of 12-31-92..... 20

Table 4 Operations of the Consolidated Nonfinancial Public Sector.. 26

GRAPHS IN TEXT

Graph 1 Real GDP Growth Rates 1980-1992..... 23

Graph 2 Consumer Price Index 1980-1992..... 24

Graph 3 Consumer Price Index, January 1990-December 1992..... 24

Graph 4 Non-Financial Public Sector Deficit as Percent of GDP 1986-1992..... 25

Graph 5 Non-Financial Public Sector Revenues & Grants as Percent of GDP, 1986-1992..... 25

Graph 6 Nominal & Real Effective Exchange Rate, Quarterly Index: 1980=100..... 29

ANNEX A - El Salvador Policy Reform Matrix - All Donors

LIST OF ABBREVIATIONS AND ACRONYMS
(Alphabetical order)

AID	Agency for International Development
ANDA	National Water and Sewerage Association
ANTEL	National Telecommunications Association
CA	Court of Accounts
CABEI	Central American Bank for Economic Integration
CBI	Caribbean Basin Initiative
CEL	Hydroelectric Commission for the Lempa River
COMURES	Organization of Mayors of El Salvador
CONARA	National Committee for Restoration
COPAZ	Commission for Peace
CRB	Central Reserve Bank
EEC	European Economic Community
ESAF	El Salvador Armed Forces
ESF	Economic Support Fund
EPZ	Export Processing Zone
FIS	Social Investment Fund
FMLN	Farabundo Martí National Liberation Front
FOES	Salvadoran Labor Management Foundation
FOSAFFI	Financial Restructuring and Strengthening Fund
FUSADES	Salvadoran Foundation for Economic and Social Development
GDP	Gross Domestic Product
GOES	Government of El Salvador
GSP	Generalized System of Preferences
HCOLC	Host Country-Owned Local Currency
IBRD	International Bank for Reconstruction and Development (World Bank)
ICITAP	International Criminal Investigative Training Assistance Program
IDB	Inter-American Development Bank
IFI	International Financial Institution
ILO	International Labor Organization
IMF	International Monetary Fund
ISDEM	Salvadoran Institute of Municipal Development
ISL	Investment Sector Loan (IDB)
MEA	Municipalities in Action Program
MOE	Ministry of Education
MOF	Ministry of Finance
MOL	Ministry of Labor
NCJ	National Council of the Judiciary
NEER	Nominal Effective Exchange Rate
NGO	Non Governmental Organization
NIR	Net International Reserve
NRP	National Reconstruction Program
ONUSAL	United Nations Observers and Peacekeeping Mission for El Salvador
PAAD	Program Assistance Approval Document
PNC	National Civilian Police Force
P&NRP	Peace and National Reconstruction Program
REER	Real Effective Exchange Rate
SAL	Structural Adjustment Loan
SETEFE	Technical Secretariat for External Financing
SIU	Special Investigative Unit
UNDP	United Nations Development Program

UNICEF	United Nations Infant and Child Emergency Fund
UNOC	National Union of Workers and Farmers
USAID	U. S. Agency for International Development
USG	United States Government
USDA	U. S. Department of Agriculture
USTR	U.S. Special Trade Representative
VAT	Value-added Tax
WHO	World Health Organization

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FY 1993 ESF ECONOMIC AND DEMOCRATIC REFORM PROGRAM
CONCEPT PAPER

I. SUMMARY AND CONCLUSIONS

This Concept Paper presents the Mission's FY 1993 ESF Program for supporting El Salvador's efforts to implement and deepen its economic and democratic reforms. The ESF Program will support Salvadoran policies and other actions that can help the country attain a GDP growth rate of at least 5 percent on a sustainable basis, expand employment and social services, consolidate the historic peace process and democratic reforms agreed to in the Peace Accords, and increase United States exports to El Salvador. Continued economic growth and stronger democratic institutions are essential to the peace process and preparations for the all important national elections scheduled for March 1994. The consolidation of the peace process and economic reforms increase confidence that promotes higher levels of private investment. These strengthen the country's economic growth and prepare the groundwork for an orderly phasedown of Salvadoran dependence on donor assistance.

The Mission requests authority to develop and negotiate a $70 million ESF Program Assistance Approval Document (PAAD) to be authorized by May 31, 1993. This Program will be disbursed in two equal tranches tied to GOES compliance with the implementation of economic and democratic reforms shown in the FY 1993 ESF Policy Matrix (attached). The ESF dollars will finance private sector importation of United States raw materials, capital goods, agricultural inputs and petroleum products thereby contributing to U.S. exports and employment. Sale of U.S. dollars to Salvadoran importers generates local currency that assists the GOES and NGOs expand high priority programs especially for supporting the Peace Accords, promoting employment generation and basic social improvements, and financing other important development activities.

In 1992 El Salvador made historic progress implementing the Peace Accords and adopting the democratic reforms embodied in them. The Peace Accords signed on January 16, 1992 brought an end to a long and bloody 12-year civil war and led to major reductions in El Salvador's Armed Forces (ESAF) and demobilization of FMLN guerrillas. On December 15, 1992, the United Nations Secretary General, together with the GOES and FMLN, declared El Salvador's civil war officially ended. By early 1993 the FMLN had completed demobilization of its 8,500 ex-combatants and begun their reintegration into the civilian life of the country. The ESAF has been reduced from over 60,000 to approximately 30,000. An unprecedented purging of the ESAF Officer Corps is being implemented and military reforms have been adopted. A new National Civilian Police Force (PNC) and Police Academy are being established under civilian control. A United Nations negotiated land transfer program is ongoing that gives first priority to FMLN ex-combatants. Other assistance programs are underway including efforts to document and register to vote

ex-combatants and the civilian population in the formerly conflictive areas of the country.

Major judicial, electoral and human rights reforms have been adopted by the National Assembly. These include, among others, a new Electoral Code, the creation of a more representative National Council of the Judiciary and reforms to strengthen the Judicial Career Service. A law was enacted guaranteeing individuals the right to public defense and revisions of the criminal codes are in the final stages of drafting. The role of the Supreme Electoral Tribunal has been strengthened and the FMLN has been incorporated as a democratic political party. A new Human Rights Ombudsman Office was established and initiated operations in mid-1992. Civilians have been selected to replace military officers directing the Special Investigative Unit (SIU) and a plan has been developed for the SIU's complete civilianization. Some progress was made in developing a reformed Labor Code and discussing it in the Economic and Social Forum created by the Peace Accords. In late February 1993 a historic Social Pact was signed by labor, private sector and GOES representatives committing the country to develop a new Labor Code by September 1993 as well as undertake other actions to improve labor-management relations. Judged by any standard, the democratic reforms adopted by El Salvador in 1992-93 are clearly of historic dimensions.

With the war over, the GOES also initiated a five-year, $1.4 billion National Reconstruction Program (NRP) to rebuild the country and reintegrate formerly conflictive areas into the growing national economy. At a March 1992 World Bank-led Consultative Group Meeting the donors pledged $800 million to help El Salvador finance the NRP although final commitment and disbursement of these funds have been slower than expected. The NRP assists in the transition of ex-combatants to a peacetime economy by providing them with training, scholarships, job placement, credit and technical assistance; transferring land and agricultural credit to ex-combatants and small farmers; reactivating the economy in the formerly conflictive areas through employment generation financed by the Municipalities in Action Program and the Social Investment Fund; reestablishing basic education and health services; repairing and rehabilitating the country's war torn infrastructure and implementing the democratic reforms included in the Peace Accords. A Consultative Group Meeting is scheduled for April 1, 1993, that will be seeking fast disbursing NRP support. Timely and effective implementation of the NRP is essential to the successful consolidation of peace in El Salvador.

Even though fully involved with the historic peace process, national reconstruction and reconciliation, the GOES pressed ahead with its economic reform program in 1992 determined not to let it be undermined during the country's transition from war to peace. Key policy reform gains included further trade liberalization, elimination of interest rate controls, the introduction of a value-added tax, a major increase in electricity tariffs, strengthening the financial system including completing the privatization of three commercial banks, and improving public sector accountability by upgrading financial management and auditing. Significant progress was also made in continuing to diversify El Salvador's sources of international assistance by maintaining IMF support, completing a World Bank SAL I Program and initiating work on SAL II, signing an IDB Investment Sector Loan and other

large IDB loans, completing a USG debt reduction agreement, and obtaining commitments of new assistance from the EEC, Japan, Germany and other donors.

The economy continues to respond impressively to the improved economic policies, democratic reforms and the advent of peace. Real output grew 4.6 percent in 1992, the highest growth achieved in 14 years. Major gains were registered in employment and investment. Agricultural policy reforms, including a price band system, contributed to the largest basic grain harvest on record while increasing small farmer incomes and rural employment. Beginning in August 1992, inflation surged, the result of the introduction of the value-added tax, of adjustments in utility and public transportation rates, and looser monetary policy. Preliminary data suggest that the benefits of the economic adjustment and recovery are reaching the poor. For example, the percent of urban households living in poverty declined in 1992 and there was a significant expansion in primary education and health services. Additionally, total employment increased by up to 120,000 during the past three years. The GOES also made operational an impressive social safety network. This includes the Social Investment Fund (FIS), the National Reconstruction Program, the Municipalities in Action Program and other activities that have cushioned the effects on the poor of the economic adjustment process.

Notwithstanding such progress, however, serious problems remain. The fiscal situation deteriorated sharply in 1992 primarily reflecting higher than expected expenditures to implement the Peace Accords as well as lower coffee export tax revenues and delayed implementation of key fiscal measures. Due to lackluster export performance, the trade deficit widened considerably in 1992. In real terms, merchandise exports represented only 29 percent of the level of the late 1970s. Moreover, even with three consecutive years of solid economic growth, real per capita GDP is still 22 percent below that of 1978. Urban poverty rates, while lower in 1992, are still high, and the 1992 resurgence of inflation, even if only transitory, may have affected gains made by the poor since 1989.

Further clouding the horizon were changes in U.S. policy that could adversely affect Salvadoran economic growth and implementation of the Peace Accords. The passage of Section 599 of the FY 1993 Foreign Assistance Appropriation Legislation has virtually stopped this country's foreign investment promotion and the development of new Free Zones that were projected to create 100,000 new jobs in the 1990s (see San Salvador 1612 for further details). A change in USTR/USDA policy (see State 55864) has required the GOES to commit itself to an accelerated phase out of its agricultural price band system with unknown consequences on Salvadoran efforts to improve small farmer incomes and to reintegrate large numbers of ex-combatants receiving land and agricultural credit for basic grain production. El Salvador's potential loss of its GSP privileges, which would have devastating effects on this country's non-traditional exports and employment, may have been averted by the signing of the Social Pact, although a final USG decision on this issue will be made on April 1, 1993 (see San Salvador 1758 for details).

Furthermore, while many donors have pledged large amounts to help El Salvador finance its NRP, they have been exceedingly slow in committing and

disbursing these funds. There are major gaps in funding the PNC, land transfers, ex-combatant assistance, implementation of democratic reforms and other high priority Peace Accord and NRP activities. As a result, in 1993-94 the GOES may be forced to increase its own domestic financing for these programs thereby increasing the money supply, raising inflation and possibly reversing the excellent economic performance experienced to date.

The proposed FY 1993 ESF Program will help El Salvador keep its significant economic and democratic reform momentum moving in a positive direction in the important period of consolidating the peace process. The March 1994 national elections will probably be a referendum on the Peace Accords as well as on the economic and democratic reforms implemented in recent years. They will also be the first in which the FMLN participates as a democratic party and, as such, will be a major milestone in the consolidation of Salvadoran democracy and the peace process. The successful completion of these elections will further strengthen the peace process which is one of the most important USG foreign policy objectives in Central America.

This fast-disbursing ESF Program will provide budgetary resources to support implementation of GOES economic and democratic reforms. Together with other donors' policy-based programs, it will consolidate and deepen free market reforms required to improve domestic and foreign balance and produce an annual GDP growth rate of at least 5 percent. The main economic reform areas supported with ESF include: improving GOES fiscal performance by further rationalizing the electric power sector, modernizing tax and customs administration, and reducing the size of the public sector; implementing municipal revenue reforms, continued strengthening of the financial system, further trade liberalization, compliance with other donor policy-based programs, improved environmental policies and progress in resolving an outstanding expropriation case. Support will also be provided for reforms that improve the efficiency of the education and health sectors and accelerate implementation of the judicial, electoral and labor reforms included in the Peace Accords and in a recently signed Social Pact. Finally, improvements will be continued in public sector accountability by deepening GOES efforts to upgrade its financial management and auditing.

Successful implementation of these 1993 measures will greatly enhance El Salvador's prospects for achieving sustained economic growth, consolidating the peace process and democratic reforms, and attracting other donor support. Such growth will also be essential to provide increased private investment and employment opportunities, especially for ex-combatants and others dislocated by the civil war, and to complete the rebuilding of the economy, all of which are necessary to fully consolidate the peace process.

Completing the economic and democratic reforms supported by the FY 1993 ESF Program will be particularly difficult during the politically-charged period leading up to the March 1994 national elections. Strong opposition is already starting to mount and GOES "adjustment fatigue" could lead to some backsliding on important reforms. Also, as a result of the peace process itself, additional interest groups have entered the political arena. While this is unquestionably a positive development overall, it also complicates GOES efforts to implement certain measures such as controlling the fiscal

deficit and deepening free market reforms. USG and other donor support at this critical juncture will greatly increase the probability of success and help set the stage for the watershed democratic transition in 1994.

Given El Salvador's open foreign trade and exchange regime, and its need for a fast-disbursing flexible form of assistance, the cash transfer mode of non-project assistance is proposed for this ESF Program. This will provide maximum leverage to support major economic and democratic reforms which are expected to result in higher rates of growth of GDP per capita. A sustainable 5 percent GDP growth rate of the Salvadoran economy throughout the 1990s will also generate $11 billion in United States exports thereby supporting more than 200,000 person years of U.S. employment.

The local currency generated by the ESF Program will provide resources to help fill the fiscal gap in 1993-94 and finance activities associated with the Peace Accords, the national elections of 1994 and basic social services such as health and education. It will also provide counterpart support to high priority GOES projects supported by AID. The dollars provided by this ESF grant will finance United States exports for the Salvadoran private sector and will facilitate the achievement of GOES 1993 Economic Program objectives of continued real growth, employment creation and lower inflation. The Mission will continue to follow the separate dollar account procedures developed for its FY 1991 and FY 1992 ESF cash transfer programs.

The specific policy reforms and measures supported by this ESF Program are outlined in the attached matrix. Mission recommends that it be authorized to develop and negotiate a PAAD with disbursement in two tranches, one in July and the other in November.

ISSUES

Some of the key issues impacting on this ESF program are as follows:

Potential Loss of GSP and Labor Code Reform

The AFL-CIO and others, on behalf of several of El Salvador's major unions, filed a complaint in 1990 with the Generalized System of Preferences (GSP) Subcommittee chaired by the USTR claiming that the GOES had not adequately protected and promoted internationally recognized worker rights. Consequently, EL Salvador was placed on the GSP Subcommittee's watch list of countries under review based on worker rights provisions of the U.S. GSP trade legislation. In March the Subcommittee will review the status of GOES performance on protecting labor rights. Should the Subcommittee find that the GOES has not made satisfactory progress in improving labor rights in El Salvador, it could recommend that El Salvador's GSP trade privileges be revoked. Should this happen, it would have a major adverse impact on El Salvador's growing nontraditional exports to the U.S., totalling $300 million in 1992, and on employment.

Such a development could not come at a worse time for El Salvador. The country is now trying to consolidate its peace process and needs to integrate tens of thousands of ex-combatants into an expanding national economy. The

10

loss of GSP would seriously threaten chances for a successful consolidation of the peace process and make it extremely difficult to achieve the economic growth and other macroeconomic targets included in the FY 1993 ESF Program.

Encouraged by the USG through FY 1992 ESF conditionality, the GOES has made progress on the development of a new labor code. In late 1992, a draft law reforming the existing code was prepared by the GOES but was not submitted to the Legislative Assembly. The draft code included several improvements over existing legislation, but fell far short of adequately addressing important labor issues, some of which led to the original GSP complaint. The draft code was also presented to the Economic and Social Forum established in the Peace Accords. The Forum is also considering draft proposals from the business community and from labor.

In February 1993, a major breakthrough was achieved in the Forum when its members, including labor leaders, business representatives and GOES officials, signed a Social Pact which contained several agreements on principles and commitments with respect to improving labor conditions, worker rights and labor-management relations in El Salvador. Labor leaders from across the political spectrum have characterized this pact both publicly and in writing as containing obvious steps to improve internationally recognized labor rights in El Salvador. As a result, Salvadoran labor unions (e.g., UNOC) have argued against a loss of GSP benefits for El Salvador.

The Pact addresses key elements of the GSP complaint including the labor code, enforcement of labor regulations, ratification of ILO Conventions, and the right of association. The Pact sets a deadline of April 30 for completion of tripartite review of specific ILO conventions considered high-priority by labor. The Pact also sets a deadline of September 30 for completion of a new labor code to be reached by consensus among labor, business, and GOES representatives in the Forum. The Pact calls for strict respect for the right of association as provided for in the Salvadoran Constitution. The GOES committed itself to facilitate union registration and review jointly with labor all cases where registration has been denied. These and other provisions of the pact are to be verified by a special commission which will include equal representation from labor, business, and the GOES.

Based on the important progress achieved in the Economic and Social Forum, the U.S. Mission has recommended that the GSP subcommittee find El Salvador to be taking steps to guarantee internationally recognized worker rights, and therefore remove it from the list of countries under review based on worker rights provisions of GSP legislation (see San Salvador 1758).

The proposed FY 1993 ESF program includes conditionality requiring the GOES to comply with the measures included in the Social Pact. It also requires the GOES to prepare a revised labor code negotiated in the Forum that can be submitted to the Legislative Assembly. In addition, the GOES will develop with labor leaders a plan to strengthen the Ministry of Labor and improve the application and enforcement of internationally recognized worker rights.

Report on Banco Agrícola Loan Repayments

Section 530(e)(2)(B) of the FY 1993 foreign assistance appropriations bill requires that, ..."of the FY 1993 ESF allocated for El Salvador, $20 million be withheld from expenditure until 15 days after receipt by the Appropriations Committee of a report from the Secretary of State which describes and assesses the efforts being made by the GOES to collect on loans made by the Banco Agrícola Comercial which were the subject of indictments issued during 1991."

The proposed FY 1993 ESF program includes conditionality linked to the first disbursement programmed for June that the GOES formulate a plan to recover overdue loan payments for assets currently held by the Financial Restructuring and Strengthening Fund (FOSAFFI). The Fund assumed those overdue loans of the five state-owned commercial banks, including the Banco Agrícola, prior to the banks' privatization, which were considered to be the most difficult to recover. For the second FY 1993 ESF program disbursement, we propose conditionality requiring the GOES to implement the plan, including recovery of loans issued by the Banco Agrícola. Therefore, given this conditionality sequence, we propose that the $20 million to be withheld per Section 530(e)(2)(B), be considered as part of the second tranche ESF disbursement.

Adjustment Fatigue and Donor Coordination

After almost four years of implementing difficult economic and democratic reforms, President Cristiani and some members of his Economic Cabinet are clearly fatigued by the economic adjustment and peace process. In 1992 the complex and endless negotiations among the GOES, FMLN and ONUSAL on implementation details of the Peace Accords and the NRP have slowed down economic reform momentum. A major GOES effort was needed to design the NRP, to organize the Reconstruction Secretariat and its implementing mechanisms, to begin the PNC and a new Police Academy, to make operational a new Land Bank, to begin a program for reintegrating large numbers of ex-combatants into civilian society, and to urge the entire donor community to be more responsive to NRP funding requirements. Unprecedented measures are being taken to purge the ESAF, to adopt military reforms and to implement deep and widespread judicial, electoral and labor reforms. After implementing the most significant economic and democratic reform program in Central America — and bringing peace to El Salvador — there is growing GOES reluctance to move forward on even more difficult reforms especially with national elections only one year away.

Nevertheless, President Cristiani and the GOES remain committed to the economic and democratic reforms supported by the international community. Problems often arise not over the desirability of specific reform measures but over the timing for their implementation and the need for greater donor sensitivity to local political conditions. This has forced some donors to make compromises in negotiating their policy-based programs that have not always been fully discussed with other donors. As a result, there is a growing problem of donor coordination on key measures/issues that could weaken Salvadoran resolve to continue its reform momentum in 1993-94.

For example, at an informal donors meeting on the electric power sector

12

in October 1991, it was agreed that the Inter-American Development Bank (IDB) would assume the lead role in policy dialogue in that sector. As discussed in 92 San Salvador 11978, a large IDB loan approved in December 1992 did not include conditionality on power rate increases in 1993 even though electricity rates in El Salvador are still well below long-run marginal cost. The IDB decision to proceed with this loan without rate increases was inconsistent with AID conditionality associated with the second tranche disbursement of the FY 1992 ESF Program, and it made negotiations with the IMF on a Stand-by Agreement for 1993 more difficult. This points out the need for better donor coordination and closer consultations on sector-specific conditionality.

Likewise, the IDB, IBRD and AID are still attempting to reach a consensus on 1993 measures that are needed to further rationalize the Salvadoran electric power sector. The donors are discussing, for example, the desirability of supporting the creation of an independent electricity rate setting commission as included in the FY 1993 ESF Program. The IDB may be calling a donors meeting on the power sector to better coordinate conditionality in this important sector.

Other problems have also recently emerged. Discussions on economic policy that would be supported with the FY 1993 ESF Program have been made more difficult by agreements reached in principle by the GOES with the World Bank in ongoing negotiations for a Second Structural Adjustment Loan (SAL II). It appears that the World Bank may not insist on unification of the ordinary and extraordinary budgets and that it may not require that needed legal changes be adopted to eliminate the pre-control function of the Court of Accounts. These are two areas of ESF conditionality that we had discussed with the World Bank and where we were expecting to work together on these important reforms. We expect to continue our ongoing dialogue with other donors at an upcoming Washington coordinating meeting scheduled for later in March and at the Consultative Group Meeting in April.

IMF Program

An IMF team negotiated a draft letter of intent and Memorandum of Economic Policies with the GOES in January 1993, and the IMF plans to submit a Stand-by Arrangement to its board in March 1993. This agreement will support the maintenance of an adequate macroeconomic framework in the period preceding the national elections, when there will be pressures to loosen fiscal and monetary policy. While not a formal condition precedent of the proposed ESF Program, we do not plan to make the first ESF disbursement unless the Stand-by Agreement is approved by the IMF Board.

13

FY 1993 ESF POLICY MATRIX

GOAL/OBJECTIVE		FIRST DISBURSEMENT JULY	SECOND DISBURSEMENT NOVEMBER
1. Consolidate Sustainable Economic Growth			
a. Improve Fiscal Performance			
(i) Increase the Efficiency of the Electricity Sector	1.	Present to Legislative Assembly law establishing an independent electricity rate commission.	Demonstrate good faith effort to gain Legislative Assembly approval of law establishing an independent electricity rate commission.
	2.	Prepare plan for raising electricity rates toward long-run marginal costs.	Approve plan for raising electricity rates toward long-run marginal costs.
	3.	Satisfactory progress on the installation of electricity meters, particularly for commercial and industrial users.	Continued satisfactory progress on the installation of electricity meters particularly for commercial and industrial users.
(ii) Improve Tax/Customs Administration	4.	Prepare updated customs reform plan within the context of CAUCA II.	Continue to demonstrate satisfactory progress in implementing customs reform plan.
	5.	Satisfactory progress in the modernization of the tax system, including an increase from 600 to 1,000 of the number of taxpayers audited by the large taxpayers unit.	Satisfactory progress in the modernization of the tax system.
	6.	Submit to Legislative Assembly law to make tax offenses criminal acts.	Demonstrate good faith effort to gain Legislative Assembly approval of law to make tax offenses criminal acts.
(iii) Reduce Role of the State	7.	Privatize _____ entities.	Privatize ____ additional entities.
	8.	Maintain a restrictive public employment policy, including freezing 4,000 jobs	Continue to maintain a restrictive employment policy.

FY 1993 ESF POLICY MATRIX

GOAL/OBJECTIVE		FIRST DISBURSEMENT JULY	SECOND DISBURSEMENT NOVEMBER
b. Promote Improved Governance Through Decentralization	9.	MUNICIPAL REVENUE REFORM CONDITIONALITY BEING DEVELOPED AND NEGOTIATED.	
c. Improve Financial Intermediation			
(i) Encourage Competition in Banking System	10.	Develop, approve and announce procedures for establishing new banks, both domestic and foreign.	Demonstrate that there are no restrictions to the establishment of new banks.
(ii) Improve Prudential Bank Supervision	11.	Implement plan to strengthen Superintendency of the Financial System.	Continue implementation of plan to strengthen Superintendency of the Financial System.
	12.	Draft modifications to existing legislation to improve bank supervision.	Demonstrate good faith effort to gain legislative approval of modifications to existing legislation to improve bank supervision.
(iii) Strengthen Financial System	13.	Formulate plan for recovery of past-due loans of FOSAFFI (Financial Restructuring and Strengthening Fund).	Implement plan for recovery of FOSAFFI past-due loans, including Banco Agrícola.
	14.	Initiate the preparation of a plan to reduce Central Bank losses.	Complete the preparation of a plan to reduce Central Bank losses.
d. Promote Exports and Deepen Trade Liberalization	15.	Complete a study of policy measures needed to deepen trade liberalization and prepare a strategy to promote exports.	Satisfactory progress in the implementation of a strategy to promote exports.

FY 1993 ESF POLICY MATRIX

GOAL/OBJECTIVE		FIRST DISBURSEMENT JULY	SECOND DISBURSEMENT NOVEMBER
	16.	Submit draft law eliminating all remaining tariff exemptions for CEL, ANDA and ANTEL for imports financed with internal sources.	Demonstrate good faith effort to gain Legislative Assembly approval of law.
e. Maintain Adequate Macroeconomic Framework and Structural/Sector Adjustment Policies	17.	Adhere to economic program targets.	Adhere to economic program targets.
f. Rationalize Public Education and Health Spending	18.	To improve the quality of health services, initiate a pilot program to increase cost recovery.	Demonstrate satisfactory progress in the implementation of a pilot program to increase cost recovery and develop a strategy to extend the program.
	19.	CONDITIONALITY ON BUDGET ALLOCATION FOR THE BASIC EDUCATION SECTOR BEING DEVELOPED AND NEGOTIATED.	
g. Improve Quality of the Environment	20.	Satisfactory progress in the development of a national strategy for the protection of the environment and for the management of national resources.	Demonstrate satisfactory progress in the implementation and financing of the national strategy.
h. Improve Investment Climate	21.	Resolve outstanding investment disputes.	
2. Strengthen Democratic Practices, Processes and Procedures			
a. Improve the Administration of Justice	22.	Carry out a study(ies) on organizational effectiveness and operational needs of the Public Ministry (i.e., the Attorney General, Procuraduría (Public Defender) and Human Rights Ombudsman).	Make good faith effort to facilitate the implementation by the Public Ministry of the recommendations of the studies.

FY 1993 ESF POLICY MATRIX

GOAL/OBJECTIVE		FIRST DISBURSEMENT JULY	SECOND DISBURSEMENT NOVEMBER
	23.	Satisfactory progress in implementing the legal reform program.*	Satisfactory progress in implementing the legal reform program.
	24.	Progress in civilianization of Special Investigative Unit.	Complete civilianization of Special Investigative Unit.
b. Support Fair and Free Elections	25.	Ensure the timely disbursement of funds to the Supreme Electoral Tribunal for preparation for the national elections of 1994.	Submit to the Legislative Assembly the extraordinary budget for the Supreme Electoral Tribunal (SET) to obtain the funds necessary for the 1994 national elections, and ensure the timely disbursement of the funds.
	26.	Satisfactory progress in the reestablishment of civil registry and citizen documentation in ex-conflictive zones to facilitate citizen participation in 1994 elections.	Complete implementation of plan of the Salvadoran Institute for Municipal Development for the reestablishment of civil registry and citizen documentation in ex-conflictive zones to facilitate citizen participation in national elections of 1994.
c. Promote Respect for Worker Rights	27.	Meet the targets agreed in the Foro on the "Social Pact" ("Acuerdo de Principios y Compromisos").	CONDITIONALITY ON LABOR REFORM BEING DEVELOPED AND NEGOTIATED.
	28.	Develop and discuss with labor leaders and the private sector a GOES plan to improve the application and enforcement of worker rights.	Implement plan, including efforts to strengthen the Ministry of Labor.

* GOES will send a letter defining the schedule for the implementation of the reforms.

FY 1993 ESF POLICY MATRIX

GOAL/OBJECTIVE		FIRST DISBURSEMENT JULY	SECOND DISBURSEMENT NOVEMBER
3. Strengthen Integrated Financial Management and Auditing			
a. Increase Accountability for the Use of Public Resources	29.	CONDITIONALITY ON THE COURT OF ACCOUNTS BEING DEVELOPED AND NEGOTIATED.	
	30.	Demonstrate satisfactory progress in implementing GOES commitment to unify ordinary and extraordinary budgets.	Demonstrate satisfactory progress in implementing GOES commitment to unify ordinary and extraordinary budgets.
	31.	Demonstrate satisfactory progress in the action plan to improve integrated financial management.	Demonstrate satisfactory progress in the action plan to improve integrated financial management.
b. Improve Public Sector Cash Management	32.	CONDITIONALITY ON PROMPT PAYMENT BEING DEVELOPED AND NEGOTIATED.	

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II. PROGRAM RATIONALE AND RELATIONSHIP TO MISSION STRATEGY

A. Overall Program Rationale

1. Promote Improved Economic Performance

The proposed FY 1993 ESF program supports the adoption and maintenance of economic policies that promote sustained higher levels of economic growth. In the period 1962-73, real GDP grew by 5.0 percent *per annum*, but the rate of growth declined to 0.5 percent in 1974-89. Since then, growth has accelerated steadily, reaching 4.6 percent in 1992, the highest rate of the past fourteen years. The rate of growth of 1992 is even more remarkable considering coffee prices have been, in real terms, at their lowest historical levels, and that the prices of other traditional exports are also relatively low. This means that the economy has become more resilient to external shocks, a result of greater diversification of exports and of capital inflows and remittances. Improved economic performance of the past three years has been the result of the comprehensive and coherent economic reform program which began to be implemented in 1989.

The proposed ESF Program has been designed to support the deepening and consolidation of those economic policies. This is expected to reduce government consumption, encourage savings, increase the level and efficiency of private and public investment, deepen financial intermediation, and increase the openness of the economy. In addition, the program will support improvements in the quality of education and health services. Empirical studies of the effects of economic policy on growth (summarized in William Easterly, "How Much Does Policy Affect Growth") lead to the conclusion that the continued implementation of those policies could increase *per capita* income growth by about 4 percent *per annum* over the rate of growth if the reforms are not implemented. Over a decade, this would result in a real *per capita* level of income almost 50 percent higher than if the policies are not implemented and maintained.

2. Promote Democracy and Human Rights

The proposed ESF Program gives particular emphasis to the strengthening of democratic institutions and processes. While historic reforms of the justice system have removed many significant structural constraints to the fair and impartial administration of justice, there is a need to fully implement the legislation that has been enacted. The justice sector reforms supported by the ESF Program will increase equality, timeliness, respect for human rights and will tend to reduce transaction costs, thus increasing economic efficiency. The provision of adequate financing for the electoral process will help guarantee greater participation and transparency in the crucial national election of March 1994. A free and fair election in 1994 will represent a major step in the consolidation of democracy in El Salvador, and will contribute importantly to the peace process.

In addition, the higher rates of sustained growth discussed above can

only be reached if democratic institutions and processes are strengthened, and peace is consolidated. Our estimates indicate that the substantial improvement in the judicial and democracy situation of El Salvador which is under way can raise GDP growth on a sustainable basis by perhaps a full percentage point (see Economic Analysis of El Salvador Judicial Reform II Project).

While the situation has improved recently, labor relations in El Salvador have been strained. A new labor code is being negotiated between the government, labor, and the private sector. The present government proposal contains major improvements over existing legislation. It does not, however, fully address problems that led to the complaint that could result in a loss of access to GSP by El Salvador. Specifically, labor rights of agricultural and public sector employees are not guaranteed fully. In February 1993, a major breakthrough was achieved when GOES, labor and business leaders signed a social pact pledging to reach a consensus on a new labor code by September 30. The ESF Program will support the preparation of an improved labor code and greater application and enforcement of worker rights. All these measures would tend to reduce labor-management confrontations and permit Salvadoran exports continued access to the U.S. market under the Generalized System of Preferences (GSP). Without this access, the export-led growth strategy of the GOES would fail.

3. Provide Fiscal Support

The proposed ESF cash transfer will provide essential budget support to the GOES during 1993. Notwithstanding noteworthy efforts to improve fiscal performance, budgetary support is still needed to keep the GOES economic and social program on track while also assuring timely implementation of the Peace Accords.

As amply described in other sections of this document, while overall GOES policy reform performance has been excellent, serious fiscal difficulties persist. In 1992, the deficit mushroomed to 5.6 percent of GDP, way above the original program target of 2.3 percent and a sharp deterioration from the 4.4 percent registered in 1991. A large part of this deficit widening was due to factors beyond GOES control, e.g. the drought, plunging coffee prices and major additional unbudgeted expenditures required to implement the historic Peace Accords. Moreover, this deterioration detracted from many notable fiscal achievements in 1992 including the introduction of a value-added tax, improvements in tax and customs administration, a public sector hiring freeze combined with the voluntary separation/early retirement of 15,000 employees, strict current spending controls, a reduction in public energy subsidies, and the sale of major public assets. In fact, had the GOES not implemented these measures, the 1992 fiscal deficit could have been as high as 8 percent of GDP.

The GOES has demonstrated its commitment to improve fiscal performance and continues to implement measures designed to accomplish this. Reflecting this, several measures proposed below as conditionality for the FY 1993 ESF program are aimed at encouraging such efforts. In addition, the Mission is funding a $6.5 million Modernization of the Salvadoran Tax System (MOST) Program initiated in late 1991 which provides high caliber,

20

state-of-the-art technical assistance to support GOES efforts to improve tax policies, enhance tax enforcement and administration, and modernize customs operations. Already substantial progress has been noted. As a percent of GDP, noncoffee tax revenue rose from 7.5 percent in 1989 to 8.6 percent in 1992. By 1995 total tax revenues are expected to reach near 12 percent of GDP.

In the meantime, however, a major fiscal gap remains. While modest further gains in tax revenue are expected in 1993, the full impact of GOES tax modernization efforts will not materialize until 1994 and beyond. The same is true regarding El Salvador's so called "peace dividend." The 50 percent cut in military personnel completed in early 1993 will result in major budgetary savings. However, such savings will not be realized until 1994 and beyond as substantial severance pay and other benefits have to be made in 1993 to officers and career soldiers discharged in accordance with the Peace Accords. In addition, with the first national elections since the Peace Accords scheduled for March 1994, the GOES will have to finance a number of costly preparatory activities during 1993 and in early 1994.

Therefore, the strain on the GOES budget will be great during 1993. The proposed FY 1993 ESF program, through local currency generated by cash transfer dollars, will provide crucial and timely finance to the ordinary and extraordinary budgets, and will permit the financing of activities necessary for the consolidation of the peace process and for the expansion of social services such as health and education.

B. Need for Program Assistance

1. ESF Leverage Essential to Support Critical Reforms

The Mission relies on two major modes of assistance to achieve its strategic objectives: (1) project funding, and (2) cash transfers. Project funds are used largely to finance technical assistance, commodities, and other inputs to specific development projects. On occasion, project funding is also used to support the Mission's policy dialogue agenda. Conditions precedent to disbursement are contained in several key projects to support GOES compliance with policy reforms and other actions required for successful project implementation and in support of overall Mission strategic objectives. However, the leverage provided by project funding is less significant in supporting GOES implementation of many reforms of critical importance for the achievement of Mission objectives and other measures of particular concern to the USG.

Fast-disbursing cash transfers, on the other hand, provide major leverage for policy reform. They are used to support macroeconomic stabilization and structural/sectoral adjustment policies while also quickly providing additional financial resources to facilitate the achievement of GOES economic program objectives. As such, ESF cash transfers are a valuable complement to project funding. The additional leverage provided by quick-disbursing cash transfers has been instrumental in supporting GOES implementation of key economic and democratic reforms over the last several years, and will be especially critical in 1993 to encourage the consolidation

and deepening of such reforms before the term of the current GOES administration expires. Such leverage will be particularly needed to maintain policy reform momentum and prevent backsliding during the politically-charged period leading up to the March 1994 national elections.

The leverage provided by the Mission's ESF cash transfer program provides an important reinforcement to that provided by other international donors. As a result of El Salvador's improved economic policies and democratic reforms, the IMF, the World Bank and the IDB have all commenced policy-based program lending activities for El Salvador. Indeed, the initiation of such programs has provided important additional support for Salvadoran reforms while the amount of ESF cash transfers programmed for policy reform has gradually declined from over $200 million in 1987 to the $70 million proposed for 1993.

However, notwithstanding the increasing involvement of other donors, there is still a vital role for the USG. First, the funds of other donors are largely provided on a loan basis, are therefore somewhat less attractive, and thus provide less leverage. Moreover, it is not uncommon for countries with IMF and IBRD programs in process to experience slowdowns and/or backsliding in their policy reform efforts. The added incentive provided by ESF cash transfer grants can be decisive in keeping such reform programs moving forward.

In addition, the extra leverage provided by the proposed program will aim to ensure adequate progress on those specific measures of particular interest and importance to the USG. Some of these measures often are not high on the agendas of the other donors. Moreover, on occasion efforts by other donors to gain specific reforms are abandoned in mid stream such as was the case when the IDB failed to require important electric rate adjustments as conditionality for disbursement of its power sector loan. Regarding the proposed FY 1993 ESF program, many of the individual measures included in the policy reform matrix represent actions not included in other donor programs, e.g., those related to judicial reform, improvements in the labor code, integrated financial management, and resolution of an international expropriation case.

2. El Salvador's Need for Fast Disbursing Program Assistance

El Salvador has embarked on an ambitious program to rebuild its war torn country and consolidate peace. A year ago it initiated its $1.4 billion National Reconstruction Program (NRP). While many international institutions and bilateral donors have pledged financial support for the Plan, it has been slow in coming. The GOES and AID has had to make up the difference.

In addition, the GOES has had to finance a wide variety of activities related to the implementation of the January 16, 1992 Chapultepec Peace Accords which, for legal or other reasons, were not eligible for donor funding. These include, inter-alia, the creation of a new civilian police force to replace the former National Police controlled by the military, development and operation of a new Police Academy, accelerated severance pay and other benefits related to the demobilization of one-half of the armed forces, a strengthened Supreme Electoral Tribunal, the creation of the Office

of the Human Rights Ombudsman, the activities of the Committee for Peace (COPAZ) and the Economic and Social Forum, the expansion and strengthening of judicial and legislative branch activities, and implementation of other democratic reforms included in the Peace Accords.

As described in the previous section, these additional expenditure requirements hit the GOES at a time when it was already experiencing severe fiscal difficulties. Reflecting this, the April 1, 1993 Consultative Group meeting on El Salvador will call for substantial amounts of quick-disbursing funds, not tied to specific projects, to be provided to El Salvador over the near term. This would enable the GOES to finance timely implementation of poverty alleviation and democratic measures agreed to in the Peace Accords while also keeping its economic program on track.

While other donors, including the World Bank, the IDB and others, have pledged fast-disbursing funds, these programs are still quite limited given the urgent needs. The limited availability of this type of other donor funding clearly underscores the importance of providing quick-disbursing ESF cash transfers to El Salvador in 1993. Therefore, the proposed $70 million in FY 1993 ESF program will utilize the cash transfer mode to provide crucial budget support for the GOES as it accelerates implementation of the measures required to keep the peace process on track during 1993, a critical year for the consolidation of peace and democracy in El Salvador.

3. Impact on U.S. Economy

The cash transfer dollars provided by the proposed program will increase demand for U.S. exports and thus support additional employment in the U.S. in two ways. First, the $70 million cash transfer will directly finance imports from the United States of raw materials, capital goods, spare parts, intermediate industrial and agricultural inputs and petroleum products. Second, the program will support the acceleration of El Salvador's economic recovery now entering its fourth consecutive year. As a result of this expansion, demand for imports of U.S. products has surged. Over the last four years gross U.S. exports to El Salvador have more than doubled from $421 million in 1988 to about $873 million in 1992. In 1993, U.S. gross exports to El Salvador are expected to reach nearly $1 billion, thus supporting the existence of about 20,000 U.S. jobs. Through the end of the decade, a sustained 5 percent real GDP growth rate in El Salvador will generate $11 billion in U.S. exports which support more than 200,000 person years of employment in the U.S.

C. Relationship to Mission Strategy

The proposed ESF cash transfer program for FY 1993 will contribute to the achievement of several key USG foreign policy objectives in El Salvador and Central America. These include consolidating the peace process, facilitating national reconstruction and reconciliation, fostering democracy, and improving El Salvador's prospects for achieving sustained economic growth with equity. The proposed FY 1993 program will achieve this by supporting specific policy reforms designed to further orient El Salvador's economy toward reliance on

competitive market forces and the private sector, and to strengthen its democratic practices, processes and procedures. In addition, the proposed FY 1993 program will provide financial support for the implementation of the country's historic Peace Accords while deepening important economic and democratic reforms.

The proposed program is fully consistent with and directly supportive of all five strategic objectives in the Mission's approved Action Plan/Program Objective Document, as follows:

Assist El Salvador to Make the Transition from War to Peace. A growing economy is absolutely necessary for the consolidation of the peace. Additionally, local currency generated under the program will provide financing for high priority Peace Accord and development programs.

Increase Equitable Economic Growth. Support for economic policy reforms will contribute directly to this objective. Certain specific measures will contribute to a more equitable growth, including: tax reform, electricity pricing, reducing trade distortions, and rationalizing public education and health spending.

Promote Enduring Democratic Institutions and Practices. A major section of conditionality in the proposed ESF program calls for deepening and consolidating democratic reforms and improvements in the administration of justice and of the electoral process and labor reforms. Other conditionality requires progress toward improving public sector accountability by upgrading GOES financial management and auditing, and information on the use of public resources is an essential requirement for effective democracy through improved governance.

Support the Development of Healthier and Better Educated Salvadorans. Human resource development and improved quality of life will be supported with ESF-generated host country owned local currency (HCOLC) for education and health-related expenditures in the GOES budget. Conditionality on education is expected to increase its quality, and conditionality on health sector cost recovery will increase the efficiency of resource allocation and make programs more sustainable.

Improve Environment and Natural Resource Management. The proposed program supports policy reforms aimed at achieving more realistic prices for electricity and this will contribute to increased conservation. The ESF program will also support GOES efforts to improve environmental policy.

Thus, the FY 1993 ESF cash transfer program helps accelerate implementation of all five of the Mission's approved strategic objectives for the FY 1992-97 period. It remains a vital instrument for supporting critically important U.S. foreign policy and development objectives in El Salvador.

24

III. RECENT ECONOMIC AND SOCIAL PERFORMANCE AND OUTLOOK

A. GOES Policy Reform Performance

1. Economic Policy Reform Performance 1989-1991

In mid-1989, after taking office, the Cristiani Administration began to implement an economic stabilization and structural adjustment program designed to correct macroeconomic imbalances and to place greater reliance on market forces. The measures implemented in the period 1989-91 have included, inter-alia: the maintenance of a restrictive monetary policy to reduce inflation; the liberalization of the exchange rate regime; the elimination of quantitative restrictions to foreign trade; far-reaching tax reform to improve the efficiency of the tax system and to reverse the decline in the tax to GDP ratio; the lowering of the maximum tariff rate to 20 percent, with a few exceptions, a reduction in the dispersion of tariff rates, and the elimination of most import duty exemptions, thus reducing effective protection; the elimination of export restrictions and of marketing monopolies for sugar and coffee; a strengthening of the balance sheets of state-owned commercial banks prior to their privatization, the successful privatization of three banks, and the passage of legislation to strengthen the supervision of banks; and elimination of interest rate controls and a wider use of indirect instruments of monetary control.

2. Performance on FY 92 ESF-Supported Measures in the Economic Area

Significant progress was made by the GOES in implementing economic and democratic reforms. While GOES achievements in certain areas were less than expected, these shortcomings were more than offset by advances in other areas, e.g., completion of particularly important and/or difficult measures, and historic breakthroughs in some areas which greatly exceeded the intent of the original measure. Areas of strong performance include the following:

Implementation of the value-added tax (VAT): A 10 percent VAT was put into effect on September 1, 1992, to replace the antiquated five percent turnover tax. While the conditionality required submission to the Legislative Assembly, the new tax was approved in July 1992. This required successful defense by the Administration in the Legislative Assembly. Almost 50,000 businesses have registered to date as VAT contributors, nearly five times the number of firms registered for the turnover (sales) tax. Preliminary information shows significantly higher VAT collections during the first months of implementation than would have been generated under the turnover tax. The rapid and effective implementation of the VAT is largely due to the technical assistance provided under the USAID-financed Modernization of the Salvadoran Tax System (MOST) Program.

Reduction of public utility subsidies: On September 1 the GOES increased electricity rates by 30 percent. This is a major adjustment towards the goal of bringing electricity tariffs closer to the long-run marginal cost of production and distribution. This rate

25

hike generated an additional 60 million colones over the remainder of 1992. On October 1, water rates were increased by 15 percent. Additionally, a detailed plan to reduce the electric meter deficit was prepared, an agreement not to make transfers to the power company in 1993 was reached, and commitment to take measures to establish an independent electricity rate commission was made.

Rationalizing Public Sector Operations: Privatization. The GOES reactivated the privatization process by developing a 1992 Privatization Action Plan, completing the privatization of a major hotel (Presidente), and initiating the privatization of the San Bartolo free zone and the sale of assets of the now dissolved grain marketing monopoly (IRA).

Employment Efficiency. Through early retirement and voluntary separation programs about 15,000 public sector employees left public sector employment.

Financial Sector Reform: Remaining controls on interest rates were eliminated, three state-owned commercial banks were privatized and the privatization process started for two more banks, and the GOES initiated a program to strengthen financial system supervision. Also, the GOES publicly announced that new domestic and foreign private banks would be permitted to open in mid-1993.

Trade Liberalization: In 1992 the GOES eliminated all import and export permit requirements for basic grains and powdered milk except for standard phytosanitary requirements. Import permit requirements for fiber sacks were also eliminated. Reductions of the tariff ceiling on most products to 20 percent was accomplished on schedule. The top rate, on a special schedule for excepted items, primarily textiles, shoes, leather products and certain vehicles was lowered to 30 percent.

Improve Private Investment Climate: In conjunction with its negotiations with the Inter-American Development Bank (IDB) on an Investment Sector Loan (ISL), the GOES has developed a comprehensive plan to improve El Salvador's investment climate. The key elements of the plan include: deepening banking sector reforms, development of a stock market, improved efficiency of the social security system for the private and public sectors, modernization and improved efficiency of the telecommunications sector, enhancing protection of intellectual property rights, an improved commercial code, and further progress in privatization.

In 1992 the GOES prepared a draft of a new **intellectual property rights** law, and it was submitted to the Legislative Assembly in December 1992. The draft incorporates comments received from U.S. Trade Representative's Office, Salvadoran groups, the American Chamber of Commerce, and an IDB consultant. Also, progress was made toward full resolution of a long standing **investment dispute** between the GOES and foreign investors. The GOES and the foreign investors

have reached an agreement on the terms of a settlement although there are some delays in making remaining payments. The first $10 million payment was made in mid-1992.

Notwithstanding these achievements, one major area where GOES compliance fell short of FY 1992 ESF program targets was in fiscal performance. While fiscal accounts remained on track over the first six months of the year, serious problems surfaced during the second semester and resulted in a consolidated nonfinancial public sector deficit, before grants, equal to 5.6 percent of GDP, far above the original program target of 2.3 percent of GDP. As detailed in Section II. B.4, several reasons for this slippage were beyond GOES control, including higher electricity generation costs due to the mid-year drought, a precipitous drop in world coffee prices and therefore in coffee export tax revenues, and major expenditure increases associated with implementation of the Peace Accords. Also contributing were GOES delays in several fiscal measures programmed for early 1992, such as the postponement of utility rate hikes, slower than expected privatization of nonfinancial sector assets, and the late introduction of the value-added tax. Moreover, the 1992 economic program anticipated a 12 percent VAT rate, but the Legislative Assembly reduced that to 10 percent.

3. Performance on IMF and IBRD Programs

IMF Stand-By Agreement

In support of the 1992 economic program, the GOES signed a Stand-by Arrangement with the IMF for the equivalent of SDR 41.5 million. The Stand-by Arrangement, approved by the IMF Board in January 1992, included quarterly fiscal, monetary and balance of payments performance targets. As of June 1992, the GOES was in compliance with all performance targets except that for the net banking system credit to the consolidated nonfinancial public sector. This target, however, was missed by a negligible amount (Table 1). As a result of a deterioration of the fiscal situation in the third quarter of 1992, the end-September target for this same variable was missed by 304 million colones (Table 2).

Preliminary data indicate that most IMF performance targets for December 31, 1992 were missed (Table 3). Central Government expenditures were 739 million colones higher than the target, net credit to the public sector was 488 million colones higher than the target, gross disbursements of external credits were higher than the program target, and the accumulation of net international reserves was 18 million below the target. If either the second disbursement of ESF or the last disbursement of the SAL I had been made by December 31, 1992 the net international reserve target would have been met with a margin. The limit on net domestic assets of the Central Bank was the only target that was met at the end of 1992. An IMF mission visited El Salvador in January 1993, and concluded that many of the deviations from the fiscal program were the result of factors beyond the control of the GOES such as increased expenditures to implement the Peace Accords and declining international prices for coffee. This mission also defined the performance targets for a Stand-by Program that is expected to go to the IMF Board in March 1993.

Table 1

El Salvador: Performance under the IMF Stand-By-Arrangement as of 6-30-92

	Target	Actual	Margin (+)1/ Excess (-)
(In Millions of Colones)			
Total Current Expenditures of the Consolidated Central Government (Cumulative amount from 1-01-92)	2630.0	2407.6	+222.4
Net Banking System Credit to the Consolidated Nonfinancial Public Sector (Cumulative amount from 12-31-91)	-490.0	-493.2	-3.2
Net Domestic Assets of the Central Reserve Bank (Outstanding Stock)	1190.0	845.8	+344.2
(In millions of Dollars)			
Net International Reserves of the Central Reserve Bank 2/ (Outstanding Stock)	475.0	497.3	+22.3
Gross Disbursements of External Credits to the Public Sector and the Central Reserve Bank 1/ (Cumulative amount from 6-30-92:			
Less than one year	30.0	0.0	+30.0
1-5 years	100.0	0.0	+100.0
1-12 years)	160.0	21.4	+138.6

Source: Central Reserve Bank of El Salvador.

1/ Margin (+) means the target was met, and excess (-) means that it was not met.

2/ Includes foreign credits guaranteed by the public sector or the Central Reserve Bank, but excludes restructuring operations. Credits of less than one year exclude normal trade-related credits.

18

Table 2

El Salvador: Performance under the IMF Stand-By-Arrangement as of 9-30-92

	Target	Actual	Margin (+)1/ Excess (-)
(In Millions of Colones)			
Total Current Expenditures of the Consolidated Central Government (Cumulative amount from 1.01.92)	3920.0	3211.3	+708.7 2/
Net Banking System Credit to the Consolidated Nonfinancial Public Sector (Cumulative amount from 12-31-91)	-480.0	-176.0	-304.0
Net Domestic Assets of the Central Reserve Bank (Outstanding Stock)	1415.0	877.1	+537.9
(In Millions of Dollars)			
Net International Reserves of the Central Reserve Bank (Outstanding Stock)	493.0	492.4	-0.6
New External Credits Contracted by the Public Sector and the Central Reserve Bank from January 1-June 30, 1991. 3/			
Less than one year	30.0	0.0	+30.0
1-5 years	100.0	0.0	+100.0
1-12 years	160.0	150.0	+10.0

Source: Central Reserve Bank of El Salvador.

1/ Margin (+) means the target was met, and excess (-) means that it was not met.

3/ Includes foreign credits guaranteed by the public sector or the Central Reserve Bank, but excludes restructuring operations. Credits of less than one year exclude normal trade-related credits.

2/ Estimate based on July/92 data.

Table 3

El Salvador: Performance under the IMF Stand-By-Arrangement as of 12-31-92 (Based on preliminary data)

	Target	Actual	Margin (+)1/ Excess (-)
(In Millions of Colones)			
Total Current Expenditures of the Consolidated Central Government (Cumulative amount from 1-01-92)	5590.0	6329.6	-739.0
Net Banking System Credit to the Consolidated Nonfinancial Public Sector (Cumulative amount from 12-31-91)	28.5	516.9	-488.4
Net Domestic Assets of the Central Reserve Bank (Outstanding Stock)	1849.3	1221.5	+627.8
(In millions of Dollars)			
Net International Reserves of the Central Reserve Bank 2/ (Outstanding Stock)	514.2	495.9	-18.3
Gross Disbursements of External Credits to the Public Sector and the Central Reserve Bank 1/ (Cumulative amount from 1-92:			
Less than one year	30.0	91.2	-61.2
1-5 years	100.0	0.0	+100.0
1-12 years	160.0	290.6	-130.6

Source: Central Reserve Bank of El Salvador.

1/ Margin (+) means the target was met, and excess (-) means that it was not met.

2/ Includes foreign credits guaranteed by the public sector or the Central Reserve Bank, but excludes restructuring operations. Credits of less than one year exclude normal trade-related credits.

World Bank SAL I and SAL II:

The GOES is nearing completion of its first IBRD structural adjustment loan (SAL I) and disbursement of the third and final $25 million tranche is expected in March 1993. The key obstacle to the SAL I completion had been the delays associated with the sale of the physical assets of the national basic grains marketing board (IRA), but on December 4, 1992, the GOES officially published a public notice announcing the sale of IRA assets, thus clearing this major obstacle to the last disbursement which is expected in early 1993.

A World Bank mission visited El Salvador in late October/early November and again in January/February to begin preparation of the second structural adjustment loan (SAL II). The objective of SAL II is to support GOES efforts to consolidate and deepen adjustment measures already implemented since 1989 and to support additional measures in the areas of rationalizing public sector operations, financial sector reform, further trade liberalization, social sector reform and environmental policy. An appraisal mission for SAL II is scheduled for April and Board submission is expected in September.

The World Bank is also helping the GOES organize and conduct a second Consultative Group Meeting on April 1, 1993 in Paris, France, to raise additional donor contributions for the National Reconstruction Program and Peace Accords. The GOES will be seeking fast-disbursing assistance for the new National Civilian Police (PNC) and Police Academy, land transfers, ex-combatant assistance, implementation of democratic reforms (judicial, electoral, human rights and labor reforms included in the Peace Accords) and poverty alleviation activities in the country's formerly conflictive zones. The GOES is hopeful that donors (especially the Europeans and Japanese) will provide fast-disbursing cofinancing for the SAL II Program (or for the IDB's Investment Sector Loan) as the most effective way of assisting implementation of the Salvadoran Peace Accords and NRP.

IDB Investment Sector Loan (ISL)

On November 25, 1992, the IDB Executive Board approved a $90 million Investment Sector Loan (ISL) for El Salvador. The program will support GOES measures to privatize and strengthen the financial sector, improve the efficiency of the telecommunications and transport sectors, privatize nonfinancial assets of the public sector, and improve the legal and regulatory framework in areas related to intellectual property rights, administrative procedures for private investment registration, and the commercial code.

To help cushion the effects of its structural adjustment program on the poor, the GOES also fully disbursed in 1992 its $30 million IDB loan to the Social Investment Fund (FIS) that financed over 1,500 small scale employment generation and other community development activities. A second IDB loan to the FIS is being finalized for $60 million. At the upcoming Consultative Group Meeting the GOES will be seeking donor cofinancing for the IDB/FIS program directed largely to the ex-conflictive zones.

4. USG Debt Reduction

On December 15, 1992, the USG and GOES signed an agreement reducing El Salvador's outstanding debt to the USG for AID and P.L. 480 programs by 70 percent and 80 percent, respectively, or by a total of $464 million. This will result in $19 million (or .25 percent of GDP) in fiscal savings for the GOES in 1993. El Salvador qualified for the USG debt reduction program under the Enterprise for the Americas Initiative by agreeing to implement an IMF Stand-by Arrangement, a World Bank SAL, and an IDB Investment Sector Loan (ISL), while maintaining good standing with international commercial banks. In addition, El Salvador met the four additional political requirements established in October by the U.S. Congress. These limit EAI participation to countries whose government is democratically elected, is not providing support for acts of international terrorism, is not failing to cooperate on international narcotics control matters, and does not engage in a consistent pattern of gross violations of internationally recognized human rights.

5. Trade and Investment Framework Agreement

On May 13, 1991, the USG and the GOES signed a bilateral Trade and Investment Framework Agreement. This agreement established an El Salvador-United States Council on Trade and Investment. The objectives of the Council are to monitor trade and investment relations, to identify opportunities for expanding, through liberalization, trade and investment, and to negotiate agreements where appropriate. Consultations on specific trade and investment matters of interest to both sides are being conducted when requested by either party. The Council identifies and works toward the removal of impediments to trade and investment flows, and is pursuing the goal of open markets between both countries.

The Agreement also included an annex which set the Immediate Action Agenda for bilateral discussions on trade and investment issues. The first two Council meetings took place in November 1991 and March 1992. The major topics of discussion included the protection of intellectual property rights, the status of the International Coffee Agreement (ICA), the potential impact on El Salvador of the North American Free Trade Agreement (NAFTA), the eventual participation of El Salvador and other Central American nations in NAFTA, cooperation in the Uruguay round of multilateral trade negotiations in the GATT, implementation of the Enterprise of the Americas Initiative (EAI), and the status of protecting internationally recognized worker rights in El Salvador. At the third council meeting, scheduled for March 11, 1993, it is expected that the major topics will be ICA and NAFTA updates, agricultural price bands, progress in Central American economic integration, and the status of the Uruguay round of trade talks. In particular, the GOES representatives will be asked about progress on labor code reform, further trade liberalization efforts, and resolution of international investment disputes. The proposed FY 1993 ESF program supports GOES reforms in each of these areas.

El Salvador's willingness to sign the agreement and participate in formal trade and investment discussions is another indication of its strong commitment to major economic policy reforms.

B. Economic Performance

1. Overview

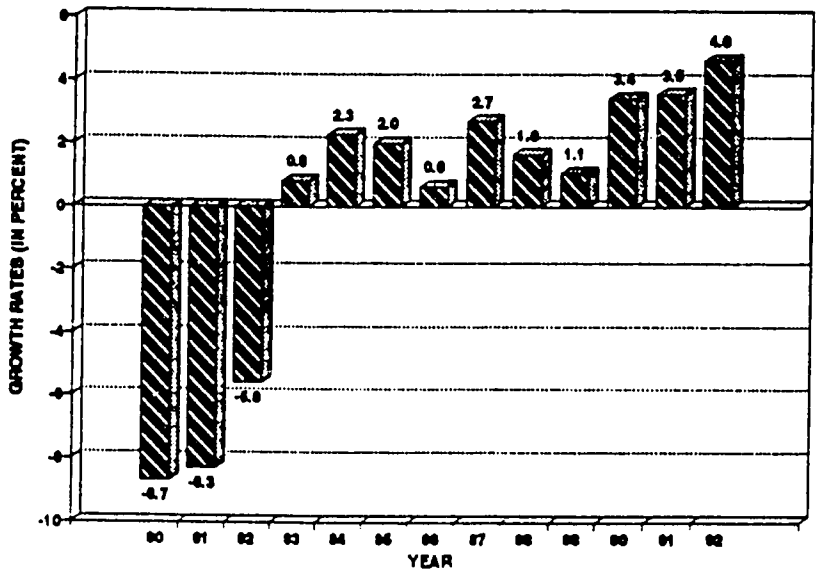
The Salvadoran economy continues to respond well to the improved macroeconomic policies of the Cristiani Government and the greatly improved prospects for a lasting peace. Output, employment and investment are up. Although a transitory inflationary surge occurred with the VAT introduction and temporary monetary accommodation, the underlying base inflation rate remains low.

2. The Domestic Economy

Real GDP grew 4.6 percent in 1992, compared to 3.5 percent in 1991, and 3.4 percent in 1990. This third year of moderately rapid growth —in the face of depressed coffee prices and a weak U.S. export market— is the result of the maintenance of an adequate economic policy framework, and represents a marked improvement over performance during 1980-89 (Graph 1). Growth in 1992 has been more balanced between economic sectors than in 1991 - agriculture in 1992 grew by 6.7 percent, and industrial output by 6 percent.

REAL GDP GROWTH RATES
1980-1992

Graph 1

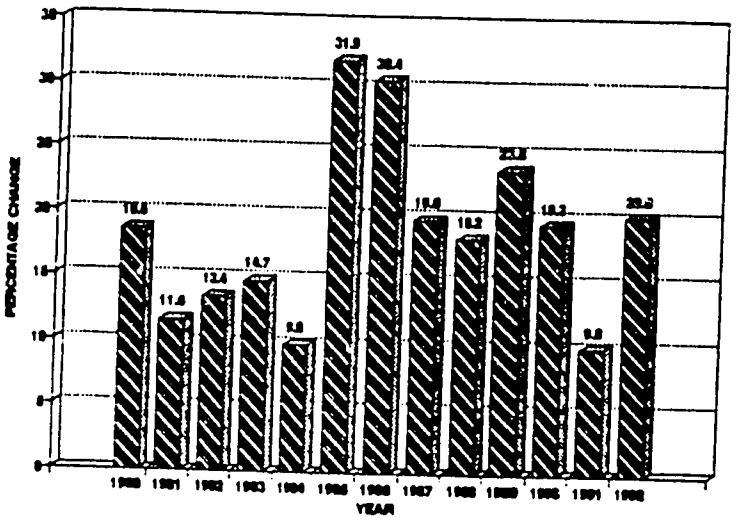


3. Prices

Inflation declined from 23 percent in 1989 to 19.3 percent in 1990 and to 9.8 percent in 1991 but increased to 20 percent in 1992 (Graph 2). During the first seven months of 1992, the consumer price index grew at an annual rate of 11 percent, substantially below the 17 percent rate registered during the same period in 1991. Beginning in August, however, inflation increased due to expectations about the introduction of the value-added tax (Graph 3). In September, with the introduction of the 10 percent value-added tax, a 30 percent increase in electricity rates, a 40-50 percent rise in public transportation fares, and a 10 percent tariff increase for milk imports, monthly inflation reached 4.7 percent. While cost increases contributed to higher prices, the fiscal deficit and a less restrictive monetary policy since April 1992 have also been significant factors in explaining the 1992 inflation rate.

CONSUMER PRICE INDEX
1980-1992

Graph 2



CONSUMER PRICE INDEX 1/
January 1990-December 1992

Graph 3

34

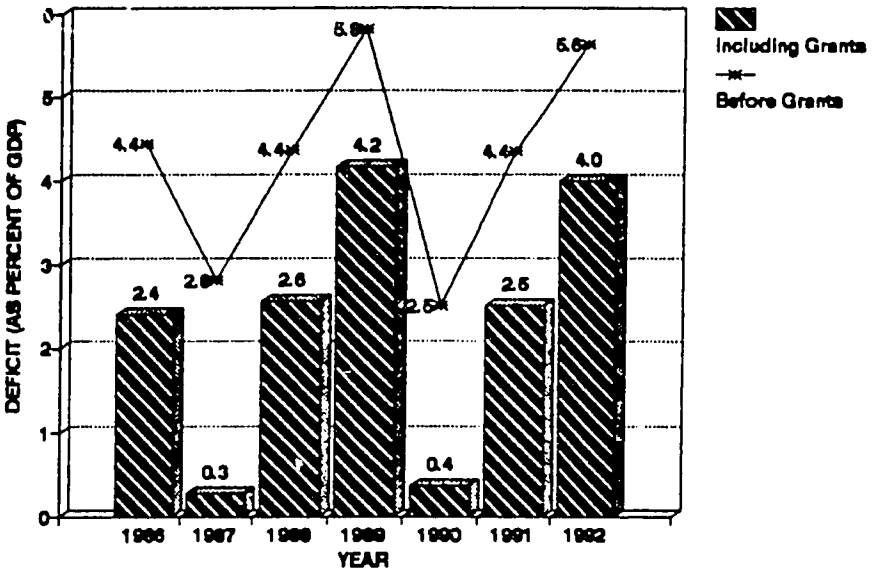
4. Public Sector Finances

As shown in Graph 4, there was a serious deterioration of the fiscal situation in 1989 as the deficit climbed to 5.8 percent due largely to the loose fiscal policy followed by the Duarte Administration and the consequences of the rebel offensive of November 1989. The nonfinancial public sector deficit (before grants) declined to only 2.5 percent of the GDP in 1990, but it increased again to 4.4 percent in 1991.

The 1992 fiscal targets established in the IMF Program were formulated excluding peace and national reconstruction plan expenditures (P&NRP), the implicit assumption being that those expenditures would be financed entirely through foreign grants but with some interim financing from the Central Bank. The data for the program and estimated performance in 1992 are summarized in Table 4. The 1992 deficit (including grants) is estimated at 4 percent of GDP.

NFPS Deficit as Percent of GDP
1986-1992

Graph 4



NFPS Revenues & Grants as Percent of GDP
1986-1992

Graph 5

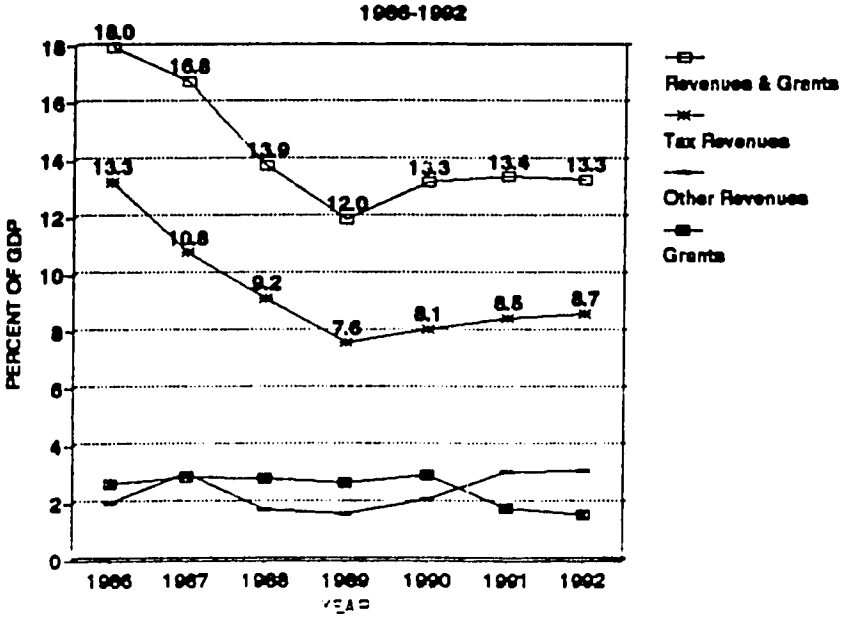


Table 4

Operations of the Consolidated
Nonfinancial Public Sector
(in % of GDP)

	Actuals				
	1986	1987	1988	1989	1990
Total Revenue	18.0	16.8	13.9	12.0	13.3
of which, grants	2.7	2.9	2.9	2.7	3.0
Expenditures	20.4	16.5	16.4	16.1	13.6
Balance					
Including grants	-2.4	-0.3	-2.6	-4.2	-0.4
Excluding grants	-4.4	-2.8	-4.4	-5.8	-2.5

	1991	1992			
		IMF Prog.	Est. a)	NRP &Peace	Total
Total Revenue	13.4	14.0	13.5	0.4	13.9
of which, grants	1.8	1.1	1.2	0.4	1.6
Expenditures	15.9	15.3	17.0	0.9	17.9
Balance					
Including grants	-2.5	-1.2	-3.5	-0.5	-4.0 b)
Excluding grants	-4.4	-2.3	-4.7	-1.0	-5.6

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a) Estimate excluding NRP and Peace Accords

b) GOES estimate, IMF estimates the deficit including grants will reach 4.4% of GDP and excluding grants 5.8%.

36

The deviations from the IMF program targets can be explained by factors beyond the control of the GOES as well as by policy slippages. The main factors affecting the deviation have been:

* a reduced level of coffee export taxes, a result of low international coffee prices (the loss estimated at about 260 million colones);

* higher costs of electricity production and lower sales because of rationing, a result of the 1991 and early 1992 drought;

* the Legislative Assembly delayed enactment of the value-added tax until September, a delay of two months, and the rate was lowered from the proposed 12 percent to 10 percent;

* the increases of electricity and water rates were delayed until September and October 1992, respectively;

* some government expenditures, notably public sector wages and interest payments, were higher than envisaged in the IMF program;

* expenditures associated with the peace accord implementation are estimated at almost one percent of the GDP in 1992, and only about half was financed by grants from foreign donors.

The GOES implemented important fiscal adjustment measures, including passage of a value-added tax, an increase in public utility rates, the sale of a major hotel, and reductions in some expenditures. The total of these measures exceeded one percent of GDP. These measures were not sufficient to compensate fully for the negative developments discussed above.

Outlook for 1993. The GOES has defined a fiscal program for 1993 which would be supported by an IMF Stand-by Agreement which is expected to be presented to the IMF Board in March 1993. The program is based on the implementation of a number of deficit reduction measures in the Central Government and in the rest of the public sector totalling the equivalent of about 1.6 percent of GDP.

Several measures designed to increase Central Government revenue have been proposed. These include a coffee export tax of 2 percent (the tax can be deducted from the income tax), the elimination of some import duty exemptions, and an increase in motor vehicle license fees. The revenue increase from these three measures is estimated at 362 million colones ($40 million). Privatization is expected to yield an additional 133 million colones ($15 million). Expenditure reduction measures, including a restrictive public sector employment policy, is expected to reduce Central Government expenditures by 200 million colones ($22 million). Other measures planned are the strengthening of a unit in the Ministry of Finance which monitors tax compliance by the largest tax payers, further strengthening of the Internal Revenue Service, passage of legislation making tax offenses criminal acts, and broadening the base of the value-added tax. When fully implemented, these

measures are expected to increase Central Government revenue by at least 350 million colones ($39 million).

A number of measures are being considered to improve the finances of the rest of the public sector. These include raising social security contributions by 12.5 percent effective April 1, 1993 (expected yield 120 million colones, or $13 million) and expenditure reduction measures in CEL, the power company.

If all the fiscal measures discussed above are implemented, the non-financial public sector deficit would be 3 percent of GDP in 1993, of which the equivalent of 2.6 percent of GDP would be financed by foreign loans, and 0.4 percent of GDP by domestic financing. This level of domestic financing is consistent with financial stability.

5. Financial Intermediation

In 1990 and 1991, the Central Bank implemented a restrictive monetary policy which resulted in sharply lower inflation in 1991 and in the first seven months of 1992. Monetary management in 1992 was uneven. During the first quarter, monetary aggregates (M1 and M2) were maintained within the limits established in the monetary program; but beginning in April 1992, their levels exceeded program targets. In the 12 months ending December 1992, banking system credit to the public and private sectors grew by 14 percent and 39 percent, respectively, while M1 grew by 32 percent and the monetary base by 22 percent. These rapid increases in key monetary aggregates are not consistent with price stability and their lagged effects are likely to exert additional upward pressures on the price level in the near term.

6. Balance of Payments

Notwithstanding a surge in the inflow of family remittances, the current account deficit in 1992 before official transfers is expected to reach 6.5 percent of GDP. This result can mainly be attributed to a major widening of the trade deficit, a consequence of low international coffee prices, slower than anticipated nontraditional export growth, and rapid growth of imports (23 percent growth in dollar terms). In 1992, imports from the U.S. surged to near $680 million ($873 including drawback imports) up from $557 million in 1991. The surge in imports can be attributed mainly to the expansion in economic activity fueled in large part by foreign investments, inventory build-up in anticipation of the enactment of the value-added tax, and a lowering of tariffs. Consequently, the trade deficit in 1992 reached about $1.1 billion (18 percent of GDP), the largest trade deficit ever. Regarding exports, coffee revenues fell $70 million, which more than offset the modest increases in nontraditional and other exports. On the bright side, drawback exports more than doubled (in terms of value added) from $20 million in 1991 to $42 million in 1992.

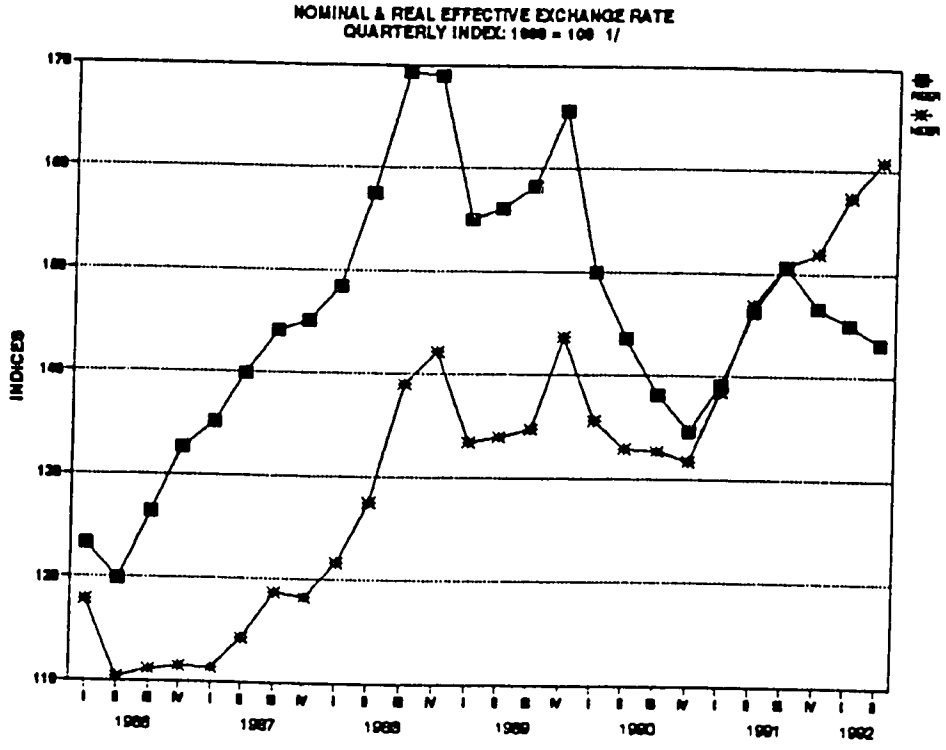
Shortfalls in official loan disbursements with respect to planned levels were more than offset by large private capital inflows. These private capital inflows facilitated an increase in net international reserves of $55 million in 1992.

7. International Reserves

The net international reserve (NIR) position of the Central Reserve Bank continued to improve in 1991 and 1992. NIRs increased by $42 million in 1991, and by $55 million in 1992. This increase in NIRs reflects the greater confidence of investors and multilateral financial institutions resulting from improved economic policies and the peace process, and higher official transfers.

8. Exchange Rate Developments

The liberalization of the exchange rate and trade regime, which began July 1989, resulted in a significant increase in export competitiveness. From the fourth quarter of 1989 to the fourth quarter of 1990, the real effective exchange rate (REER) depreciated by almost 19 percent. From late 1990 through the third quarter of 1991, the REER experienced a 12 percent appreciation, due in part to rising remittances from Salvadorans living abroad. Since then to mid-1992, there has been a slight depreciation of the real effective exchange rate (5 percent). Movements of the exchange rate are shown in Graph 6.



Graph 6

1/. A decline in index indicates a depreciation.

9. External Debt

Total public sector medium- and long-term external debt (including Central Reserve Bank debt) was 36 percent of GDP in 1992, a manageable level. The Central Reserve Bank (BCR) did not draw resources from the IMF stand-by arrangement, and it was able to prepay expensive external debt in order to reduce the debt service burden. Consequently, the BCR's outstanding external debt is estimated to have experienced a slight reduction, from $313 million in 1991 to $308 million in 1992. Total outstanding public sector debt, however, increased by $267 million (13 percent) during 1992, to a total of $2,337 million. This increase can be mainly explained by an increase in multilateral lending related to a) purchase of capital goods for CEL (generators and other equipment for energy production); b) a $45 million CABEI loan to provide assistance to coffee growers affected by low international coffee prices; and c) an estimated $45 million in disbursements from the IDB. On December 15, 1992, the USG and GOES signed a debt reduction agreement which, when finalized, will cut El Salvador's outstanding debt to the USG by $464 million -- $196 million AID debt and $270 million PL-480 debt. On a cash flow basis this provides $19 million (about 0.25 percent of GDP) in budgetary relief to the GOES in 1993.

C. Social Development

1. Economic Adjustment and the Poor

The economic adjustment process underway in El Salvador is creating a macroeconomic environment with better incentives and support for lower-income groups to become more productive, and therefore increase their incomes. Liberalization of the foreign trade and exchange regime has eliminated many of the economic rents that accrued to urban elites at the expense of the exporting agricultural sector. Trade reforms have also shifted the internal terms of trade from inefficient industrial activities to the agricultural and exporting sectors. Improvements in interest rate policies and other financial sector reforms have encouraged increases in foreign and domestic investment.

There is no doubt that the GOES economic policies have had a major favorable impact on the level of overall economic activity. Real output has grown at an average annual rate near four percent over the last three years. Moreover, real per capita GDP has increased 5.3 percent since 1989, the best three year-performance since the late 1970s. Price inflation, which usually hurts low income people the worst, was reduced from the high level of the 1985-89 period. A temporary resurgence of inflation occurred in mid-1992 primarily due to the transitory impact of the implementation of the 10 percent value-added tax which pushed the consumer price index up 20 percent for the year. It is expected that inflation rates will again drop for 1993 and beyond.

Most of the available evidence suggests that, unlike the case in some other countries undergoing economic stabilization and structural adjustment programs, the poor in El Salvador have not suffered excessive adverse effects. This can be explained by a number of factors. First, El Salvador has received major transfers, primarily from AID, over the adjustment

period. This has enabled the economy to operate at a much higher level of overall output and employment than would have been the case without such transfers. Not all countries undergoing stabilization and structural adjustment programs have had access to such large assistance inflows.

Second, the GOES has made the alleviation of poverty a major objective of its economic and social program. Sizeable portions of the donor support have been channeled directly into programs to assist the poor and, in particular, to mitigate the adverse impact of structural adjustment on those groups which are particularly vulnerable. These programs are discussed in more detail below.

Third, due to El Salvador's particular situation of experiencing substantial emigration during its twelve year civil war, large numbers of Salvadorans are now earning income abroad and remitting a portion of that income to family members living in El Salvador. These remittances are estimated to have been over $680 million in 1992, over 10 percent of GDP. Moreover, remittances are sent directly to family members, most of whom are poor. In fact, recent surveys indicate that remittances increase the incomes of poor urban and rural families by a third.

Finally, many of the specific economic policy reforms implemented by the current GOES over the last three years, while contributing to stronger overall economic performance, have also helped the poor directly. For example, the implementation of the basic grains price band mechanism in 1990, combined with the abolition of the government's basic grains marketing monopoly, the elimination of price controls on agricultural products and the replacement of an overvalued exchange rate regime with one determined by free market forces, has provided greatly improved incentives for basic grains production. In response, the area planted for basic grains expanded considerably in 1990, 1991 and 1992, and record harvests were recorded in 1990 and 1992 -- output in 1991 was hurt by drought. Value added originating in basic grains production increased in real terms over the last three years at an average annual rate of 6 percent. These sharp increases have improved the incomes of small farmers who produce most of El Salvador's basic grains.

2. Employment Trends

Preliminary survey results from the Ministry of Planning's multipurpose household survey (MPHHS) show that urban employment increased by up to 120,000 over the last three years. This lowered the open unemployment rate to 7.5 percent by early 1991, about one percentage point lower than in early 1989. In early 1992 the unemployment rate rose to 7.9 percent, reflecting primarily a huge influx of new workers into the urban labor market in response to greater employment opportunities. In addition, over the last three years as many as 100,000 part-time workers were able to convert to full-time employment. This lowered the visible underemployment rate from 12.8 percent in 1989 to 7.5 percent by 1991 and 3.5 percent in early 1992.

Regarding the rural sector, similar survey data covering recent trends are not yet available as the MPHHS did not include rural areas until 1992. Nonetheless, a Mission-funded study on the impact of structural

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adjustment on agriculture showed an increase in agricultural employment between 1989 and 1991 equivalent to about 32,000 full time jobs. In addition, there have been numerous reports since 1990 (including in early 1993) that agricultural workers have been paid wages considerably above the legal minimum wage as farmers had trouble finding available labor. This reflects the strong recovery in the agricultural sector over the last three years where real output surged 7.4 percent in 1990, maintained flat growth in the drought dampened 1991, and then jumped another 6.7 percent in 1992.

3. Urban Poverty Rates

The MPHHS shows a drop in the percent of urban households living in poverty over the last three years. In 1989, 55.5 percent of urban households reported incomes below that required to purchase a basic basket of goods and services and therefore were considered to be living in relative poverty. That percent rose slightly to 56.1 percent in 1991 but then dropped to 53.8 percent. Regarding those living in absolute poverty, i.e., those households where the combined income of all members failed to reach the level required to purchase a basic food basket, the survey indicated little change over the last three years with such households representing about 23.5 percent of all urban households. It should be mentioned that the MPHHS fails to capture a substantial portion of the average households income. Thus, the percent of urban households actually living in poverty should be considered to be substantially less than the above figures. The reason that improvement in this indicator has not mirrored that achieved in employment over the last three years can be explained, in part, by substantial urban migration over the last few years. The number of urban household have increased 12.9 percent from early 1989 to early 1992, growing almost twice as fast as El Salvador's overall population which increased by an estimated 6.5 percent over the same period.

4. Selected Social Indicators

Several social indicators show some improvement in the condition of the poor during the adjustment period. For instance, urban homes with piped water rose from 58 percent in early 1989 to 65 percent in early 1992. For the urban poor, in particular, the percentage of homes with piped water jumped from 43 percent in 1989 to 51 percent in early 1992. Similarly, urban homes with indoor toilets rose from 48 percent in 1989 to 53 percent in 1992; for the urban poor the increase was from 30 percent to 36 percent. Poor urban households with electricity increased to 89 percent in 1992 from 84 percent in 1989. Regarding home ownership, in 1992 the percent of poor families who owned their place of residence increased to 59.1 percent compared to 52.6 percent in 1989.

5. Social and Employment Generation Programs

Notwithstanding this progress, many Salvadorans have yet to fully participate in the country's accelerating economic expansion. In addition, there are significant categories of vulnerable groups which require special attention to prevent undue hardship as the adjustment process continues. These people generally include those currently living in urban shantytowns,

the unemployed and underemployed, and those working in low-wage jobs. They also include single mothers, especially those with small children. Many of these people are unable to purchase a nutritionally adequate food basket.

The GOES is implementing a three-pronged program to address the country's social needs and reduce poverty. First, as described above, its overall economic adjustment program is designed to create higher-paying opportunities for the poor through economic growth which stimulates an efficient use of labor. Second, it is implementing specific activities designed to improve the educational status and health conditions of the poor and hence their capacity to respond to the increased opportunities for productive employment. Third, complementing the above, is the implementation of social safety net programs for those poor groups which do not benefit immediately from the new opportunities resulting from the economic adjustment program.

In concert with bilateral and multilateral donors, the implementation of a number of existing donor-funded projects was accelerated since 1989, bolstered with new funds and expanded geographically to create as many new, albeit temporary, jobs as possible during the adjustment period. These activities include San Salvador earthquake reconstruction activities to rebuild and rehabilitate schools, hospitals, health care centers, roads and bridges; expansion of urban water and sanitation facilities; installation of rural water systems; and the construction of small scale infrastructure in rural municipalities. These jobs are providing badly needed additional sources of income for poor families. Also, the communities at large will benefit from the economic and social infrastructure that is being constructed as indicated further below.

The main components of the GOES social safety net program include the following:

Municipalities in Action Program (MEA): The largest of these safety net activities has been implemented by the AID-funded MEA. Through this program, members of poor communities gather in open town meetings to establish local investment priorities from which specific projects are chosen to be carried out. In 1991, MEA implemented approximately 480 education, health, potable water projects and other employment generation activities. In 1992, over 900 new projects were added (outside the National Reconstruction Program). Overall, MEA activities (outside the formerly conflictive areas) have benefitted about 300,000 low income individuals during the adjustment period.

Social Investment Fund (FIS): In 1990, the GOES created the FIS to finance small-scale, labor intensive projects to be implemented mostly by NGOs and local community development groups. The projects are targeted to the poorest areas of the country and are designed to promote domestic production, including local investments in infrastructure and occupational training, as well as helping low income groups meet their basic education, health and nutritional needs. FIS projects implemented in 1991 and 1992 totaled $20 million and included vocational training for 3,200 individuals, reforestation of 300 hectares, 19 nutritional projects benefitting 6,000 children,

construction of 26,000 latrines, providing 14,000 fuel-efficient Lorena stoves, and the building and equipping 1,500 classrooms and 15 health centers. In 1993 the GOES expects to increase FIS's original funding level of $30 million provided by the IDB to $120 million. The additional funds are expected from the IDB, EEC and several bilateral donors through cofinancing arrangements of a second IDB/FIS loan.

National Reconstruction Program: With the advent of peace, the GOES has initiated implementation of its $1.4 billion National Reconstruction Program (NRP) to rebuild the country and reintegrate formerly conflictive areas into the growing national economy. The NRP is assisting the transition of ex-combatants, the large majority of which are poor, to a peacetime economy by providing training, employment opportunities and other benefits. The NRP is also extending basic education and health services to the formerly conflictive areas, transferring land to ex-combatants and small farmers, and rehabilitating the country's war-torn infrastructure. To date USG assistance represents nearly 80 percent of total donor contributions to the NRP.

During the NRP's first year of operation the following has been accomplished:

- Nearly 1,200 small-scale social and economic infrastructure projects have been initiated in 115 small towns and rural communities in the formerly conflictive zones under the AID-funded Municipalities in Action (MEA) program. These include schools, health posts, market places, day care centers, electrification, and roads.

- A program has been initiated to provide land to 22,500 ex-combatants and 25,000 poor squatters. To date, 31,500 acres of government-owned land has been provided to 4,360 beneficiaries, roughly half to ex-combatants and half to squatters. In addition, the Land Bank has financed the sale of 11,200 acres of privately held land throughout El Salvador to 2,300 other beneficiaries.

- Agricultural starter packages have been provided for 7,500 FMLN ex-combatants who have chosen agriculture for their livelihood, household furnishings have been provided for 10,100 FMLN ex-combatants; and, credit has been provided to 12 FMLN support groups.

- Nearly 9000 ex-combatants have received vocational training from NGOs and AID/UNDP-sponsored activities.

- The Ministry of Education (MOE), with AID funding, has extended educational services to 60 public schools in the ex-conflictive areas by providing school materials, furniture and teachers. In addition, school materials have been provided to the 81 "Peoples Schools" operating in the ex-conflictive areas. The MOE also certified approximately 2,900 primary level and 1,400 secondary level students, permitting them to enter official classes at the beginning of the 1993 school year.

The Ministry of Health is reactivating 22 health centers and increasing services provided by another nearly 100 centers in the formerly conflictive areas. NRP-funded NGOs have opened 16 health care centers in the ex-combat areas.

Other Employment Generation Programs: As part of its policy to develop El Salvador as a country of property owners ("Un País de Propietarios" "A Country of Property Owners"), the GOES and donors have greatly increased funding to develop small and microenterprises to further generate additional jobs in low income marginal communities. These are channeled through NGOs like FUSADES' Small and Microenterprise Development Program (PROPEMI), COMCORDE, Catholic Relief Services, the banking system and government agencies like the Secretary for Family Development. Through PROPEMI, for instance, over 3,000 small loans have been made thereby generating up to 12,000 new jobs. Also, 811 Village Banks have been created throughout the country providing productive loans starting at $50 per person benefitting nearly 25,000 individuals, 90 percent of whom are self-employed women. Additional loans to nearly 400 solidarity groups have been made in amounts ranging from $250-$3,000 and benefitting almost 2,000 more individuals. Furthermore, with the advent of peace, the GOES, FUSADES and other Salvadoran agencies have greatly intensified their efforts to promote non-traditional exports and greater foreign investment as one of the most effective means of generating large numbers of new productive jobs especially for ex-combatants and others dislocated by the civil war.

Export Processing Zones ("Free Zones"): The GOES also plans to dramatically increase new job opportunities for low income Salvadorans, ex-combatants and others dislocated by the civil war by developing privately-owned Export Processing Zones (EPZ). Seventeen Zones are in development that could generate over 100,000 new jobs in the 1990s. As part of special incentives included in CBI legislation, this type of Free Zone (or "Maquiladora Park") has been successfully used in the Dominican Republic, Jamaica, Costa Rica and Honduras to increase employment and training opportunities for low income families. Similar Zones have also been successful in Mexico to cushion the impact of that country's structural adjustment and liberalization measures.

There has already been some small expansion in El Salvador's Export Processing Zones although it is still well behind other CBI countries because of the civil war. El Salvador's largest EPZ (San Bartolo) was established back in 1975 as a state-owned operation and suffered a sharp decline in activity during the 12 year civil war. In recent years, this Zone has recovered lost business and now is fully occupied with 12 factories in operation. Taking advantage of the Zone's improved economic prospects the GOES has initiated its privatization.

Three new privately-financed EPZs have been constructed (El Progreso, San Marcos, El Pedregal) and fourteen others are in the pre-construction development phase. Funding for these Zones has been provided by AID through the GOES, FUSADES, the banking system and the private sector. Their favorable impact on employment and incomes in El Salvador was cut short when the U.S. Congress added Section 599 to the FY 1993 Foreign Assistance Appropriation Act

which prohibits U.S. assistance for Free Zones (see San Salvador 1612 for further details). While El Salvador plans to continue with EPZs, their rapid development will clearly be slowed down without AID funding. Thus, one of the best means for cushioning the effects of structural adjustment on some of the poorest Salvadorans has been put in question.

6. GOES Social Spending

In the 1980s there were drastic real declines in GOES ordinary budget spending on health and education. Such drops appear to have had more of an adverse affect on education than on the health status of Salvadorans. Assistance provided by international donors, mostly from AID, have helped to cover this shortfall and have contributed to gains in the health status of Salvadorans while preventing a sharper deterioration in educational services. In recent years, the GOES has increased real spending levels for both education and health programs. Further spending increases and more efficient allocation of available resources are needed. At the May 1991 Consultative Group Meeting in Paris the GOES committed to doubling over 5 years its allocations for education and health services.

a. Health

Over the past decade El Salvador has experienced a major improvement in most general health indicators. Infant mortality dropped from 78/1000 in 1980 to 48/1000 in 1991. Child mortality declined from 70/1000 in the mid 1980s to 23/1000 in 1991. Life expectancy at birth increased from 57 years in 1980 to 64 years in 1990. In addition, contraceptive prevalence has increased and crude birth rates have declined.

These improvements were achieved due to a refocussing of public health policy toward preventive rather than curative care and with a greater emphasis on rural based health services. In addition, considerable effort by donors, such as AID, UNICEF and WHO, has been instrumental in supporting GOES efforts to expand child immunization and other child survival interventions. These improvements occurred despite a 50 percent drop in real health spending per capita by government from 1980 to 1989. (The assistance provided by AID and other donors, no doubt, helped offset this real decline.) Real spending per capita by the GOES has risen in recent years but in 1993 will still only achieve about 63 percent of the 1980 level.

The proposed FY 1993 ESF program requires that in order to improve the quality of health services the GOES implement a pilot health sector cost recovery program raising user fees. The cost recovery program will also help to better allocate public health resources between those who want specific services and are willing and able to pay while ensuring that the most basic services remain available to those in need but unable to pay. In this manner public resources will be more directly channelled to high priority preventive health services. This pilot cost recovery activity will set the basis for even more significant health sector measures that will be examined as part of an upcoming USAID-financed Health Sector Assessment.

b. Education

El Salvador is suffering a severe education deficit compared to the rest of Latin America and the Caribbean, and the deficit widened considerably during the 1980s. For instance, primary school enrollment in El Salvador was almost 80 percent of age group in 1979 but had dropped to only 72 percent by 1983. By 1988 the enrollment ratio had risen again to 80 percent, but remained well below the average for LAC. Secondary school enrollment has ranged from 22 to 27 percent of age group in El Salvador during the 1980s, while the rate has ranged from 43 to 50 percent for LAC. In 1979 LAC's overall average secondary school enrollment ratio was only 20 percentage points above El Salvador's; by 1989 the gap had risen to 25 points. The rate of progression through school in El Salvador is considerably below the average for LAC and the difference has grown in recent years. In 1979 about 58 percent of children entering first grade in El Salvador could have expected to make it through the fourth grade while the average value for LAC was about 75 percent, a difference of 17 percentage points. By 1990 the rate of progression in El Salvador had dropped to about 50 percent and for LAC the average had risen to almost 85 percent. Clearly, after a decade of war, El Salvador's education system lagged well behind the rest of the region, and that lag was growing.

This poor performance is, in part, due to the country's prolonged civil war and also reflects the impact of the 1986 earthquake which damaged or destroyed a large number of schools. Another major factor contributing to this decline in educational performance was a drop nearly in half during the 1980s of real per student government spending on education.

Since 1990, however, real government spending per primary school student has started to increase. Also, recent urban surveys indicate that the average number of school years completed per person over 10 years of age increased from 5.6 in 1989 to 6.1 in 1992. Nonetheless, serious problems remain. Teachers salaries are low, administrative costs are high and too little is spent on supplies. Repetition rates are high, especially in the early school years. Management of the school system could be improved. Multiple administrations for schools is common. A single school may have as many as four different principals. Also, there is a continuing imbalance between GOES spending per university student and primary school student. GOES spending per university student is about five times primary school student spending despite the much higher social returns to primary school spending.

In order to encourage further real GOES spending increases, the proposed FY 1993 ESF program may include measures requiring the GOES prepare a plan to give greater emphasis to basic education and to increase shares of the GOES ordinary education budget allocated for educational materials and teacher training. These changes in spending coupled with other efforts to improve teaching and school infrastructure can be expected to lead to not only greater quantity of education, in terms of enrollment, but also improvements in quality. An upcoming USAID-financed Education Sector Assessment will identify other reforms that will be included in future ESF reform programs.

IV - RECENT INITIATIVES TO STRENGTHEN DEMOCRACY

A. Background

President Cristiani's announcement in 1990 of his administration's commitment to a negotiated settlement to the civil conflict and initiation of the peace dialogue with the FMLN opened a new chapter in Salvadoran democracy. Debate on social and economic injustices of the past was opened, and groups previously with little access to decision makers found that new channels for their participation were opened.

Discussions between the GOES and FMLN continued throughout 1991, culminating with the signing of the Chapultepec Peace Accords on January 16, 1992. Agreements reached through this process are leading to far reaching changes in key democratic institutions, including the following:

- Justice sector reform, including legal reforms to improve criminal investigation and judicial procedures, organizational reforms to improve the effectiveness of the independent Attorney General's office and the Office of Public Defense, and structural and legal reforms to the judiciary to improve its independence, and that of the individual judges, from the executive branch and political or other influences; and

- Electoral code reform, including changes in the electoral oversight body as well as procedural rules governing elections;

- Individual rights, including the establishment of an independent Ombudsman for Human Rights and Labor Code reforms providing greater protection of internationally accepted workers rights; and

- Creation of a new National Civilian Police (PNC) and Police Academy under civilian control and implementation of far reaching reforms in the Salvadoran Armed Forces.

Recognizing that citizen confidence in democratic processes and institutions is key to a sustainable peace, the GOES presented a Democratic Strengthening Plan, part of its national reconstruction program and Peace Accords, to the Consultative Group meeting in early 1992. This plan describes policy and programmatic objectives with respect to the creation of a national civilian police, reforms of the electoral and justice systems, and establishment of the human rights ombudsman. Civic organizations are accorded an important role in broadening participation of conflictive-zone residents in democratic processes and local governance issues.

These significant reforms together with other factors -- such as the investigation and prosecution of military and economic elites for criminal acts, the GOES' timely, complete and transparent investigation of alleged human rights violations, and greater tolerance for open debate and opposition groups -- bode well for a sustainable peace and enduring democracy in El Salvador. The process of reconciliation is not, however, an easy one, particularly when individuals find themselves face to face with ex-combatants

who are responsible for the loss of family or personal property. Individuals on both sides of the conflict need to have their confidence restored in the democratic process and in peaceful means of conflict resolution.

B. Progress to Date

Recent progress on democratic reforms is promising. In the area of justice sector reform, two civilians have been trained by ICITAP to replace the remaining military officer leading the Special Investigative Unit (SIU); a plan was also developed for the complete civilianization of this highly competent investigative agency and discussions with the FMLN and political parties initiated on the permanent location of the Unit (i.e., within the Civilian Police or Attorney General's Office). It now appears probable that the SIU will be transferred into the new National Civilian Police (PNC) in either late 1993 or early 1994, where it will become the PNC Criminal Investigative Division. A new law was enacted in mid-1992 guaranteeing individuals the right to public defense. The GOES continues to disseminate information and hold technical discussions on the series of legal reforms included in its national legal reform program, and, the complete revisions of the criminal and criminal procedural codes are in the final stages of drafting before the launching of an extensive consultative process with the legal community and key political factions. A working group composed of lawyers from NGOs, the courts, and major political parties prepared a draft law reforming the composition and functions of the National Council of the Judiciary, the body which screens and nominates candidates for judicial appointment. This draft law was discussed and revised by COPAZ, and enacted into law by the Legislative Assembly on December 11, 1992. Revisions to the judicial career law to further strengthen judicial independence were also enacted on December 11, 1992, following review and discussion by COPAZ. The Human Rights Ombudsman was named in May 1992 and formally began operations in July. Over $1 million in GOES resources were allocated for the Ombudsman's operations in CY 1992.

In the area of electoral reform, the Constitutional reforms of 1991 strengthen the role of the Supreme Electoral Tribunal, the elections oversight body, and increase its independence through the addition of two independent magistrates. In a transitional arrangement agreed to by the GOES, the Tribunal appointed in mid-1992 includes a representative from the leftist Democratic Convergence party, as well as representatives from the three parties winning the largest share of the vote in the 1991 elections and the independent magistrate. A revised electoral code was prepared and approved by the Legislative Assembly in mid-December 1992, and the FMLN was incorporated as a political party. Recommendations of a UNDP technical mission were used in the drafting of the new electoral code.

Representatives from labor, government and the private sector appointed to the Social and Economic Forum created pursuant to the Peace Accords have also begun the lengthy task of reviewing and preparing revisions to the labor code. Although labor and government representatives were named to the Social and Economic Forum in early 1992, the business sector representatives only began to participate in September. Following early meetings of the Forum in

which operational procedures were agreed upon, and the presentation of the GOES' version of the labor code, the Forum began the process of analyzing changes to the labor code recommended by labor and government. The government's proposal contains major improvements over present legislation; however, it fails to address several key issues of labor which led to the pending complaint against El Salvador in the GSP process. Labor, private sector and GOES leaders have agreed to complete review and revision of the code by September 30, 1993. Members of the Foro have also agreed on a series of governing principles and other actions to be taken in 1993 to improve worker rights. This "social pact" signed in February 1993, marks a major breakthrough and has been heralded as containing obvious steps to improving worker rights in El Salvador.

C. Main Constraints

1. Justice Sector Reform

The justice sector reform process has entered a critical phase. Considerable momentum has been achieved in recent years through Constitutional reforms enacted in late 1991, the investigation and prosecution of military officers and economic elites for some criminal acts, and legal reform efforts and educational programs implemented in 1992. Many structural constraints to the fair and impartial administration of justice have been addressed through Constitutional reforms and the passage of reforms to the law creating the National Council on the Judiciary -- the body responsible for screening and nomination of candidates for judicial appointment; however, these need to be implemented and tangible signs of improvement made visible.

Additionally, the civilianization process of the SIU must be brought to fruition in 1993, most likely through its incorporation into the National Civilian Police. Institutional weaknesses in the public defenders' and prosecutors' offices must also be remedied, to ensure that the interests of both individuals and the state are adequately protected. Revisions to the criminal and criminal procedure codes must be completed to provide the foundation of a legal system that respects individual rights and affords all citizens access to timely, impartial justice. All of these measures are included in the GOES Justice Reform Program, support for which is provided by the FY 1993 ESF program as well as a complementary AID-funded Judicial Reform II Project.

2. Electoral Code Reform and Democratic Participation

Despite over a decade of civil conflict, the last decade has brought about positive changes towards building a stable democracy. Since 1983, five elections have been held, with each judged fair and free by international observers and an increasing number of Salvadorans participating. In 1989, the country saw its first peaceful transition in power, when the Christian Democrats yielded the Presidency to the National Republic Alliance (ARENA). The most recent elections, March 1991, saw an increase of 15 percent in voter registration and a leftist coalition of political parties, the Democratic Convergence, fielded candidates and won a number of seats in the Legislative Assembly.

Delays in the issuance of voting cards and omissions and/or errors in the voter registry have, however, resulted in some complaints, and the Supreme Electoral Tribunal is now engaged in an effort to update the electoral registry. Repatriated Salvadorans, as well as others who have for a variety of reasons not chosen to register, must also be registered. Many of these Salvadorans do not have copies of their birth certificate or citizen ID card, and will therefore have to first obtain these documents in order to prove citizenship. Over 100 municipalities will need operational support to facilitate the reconstruction of municipal records and issuance of birth certificates and citizen ID cards, many of which were destroyed during the civil war. The Electoral Tribunal has received extraordinary budget support to purchase additional computer and other equipment to support this large registration effort. Additional ordinary budget support will also need to be made available to sustain the process until March 1994 elections.

3. Respect for Internationally Recognized Worker Rights

Encouraged by the USG through FY 1992 ESF conditionality, the GOES has made some progress in the development of a new labor code. In 1992, the GOES prepared and presented a draft of a new labor code to the Economic and Social Forum. The Forum has begun the intensive process of reviewing the GOES proposal, as well as a reform proposal prepared by organized labor. While the GOES proposal offers improvements in certain areas (e.g., the power to dissolve unions is to be moved from administrative to judicial authority), shortcomings remain in at least three areas important to labor: the right of association (especially for agricultural workers), the regulation of strikes and collective bargaining. In view of the need to fully discuss and negotiate changes to the labor code through the Forum, the GOES, private sector and labor leaders agreed in February 1993 to a set of principles and agreements regarding labor rights. This "Social Pact" was signed in February 1993 and sets a date of September 30 for a consensus to be reached by all parties on a new labor code. The Pact also sets forth a number of actions to facilitate registration of unions and the investigation of complaints during the interim until a new code is enacted. A letter sent to the U.S. Embassy with the Social Pact asks that the substantial progress in improving worker rights be called to the attention of the GSP Subcommittee. In a complementary initiative in preparation for a new labor code, the Ministry of Labor (MOL) has also requested AID assistance to carry out an institutional assessment. This assessment will identify weaknesses in the GOES capacity to enforce basic worker rights and propose actions to strengthen the MOL.

V - IMPROVING INTEGRATED FINANCIAL MANAGEMENT

A. Introduction

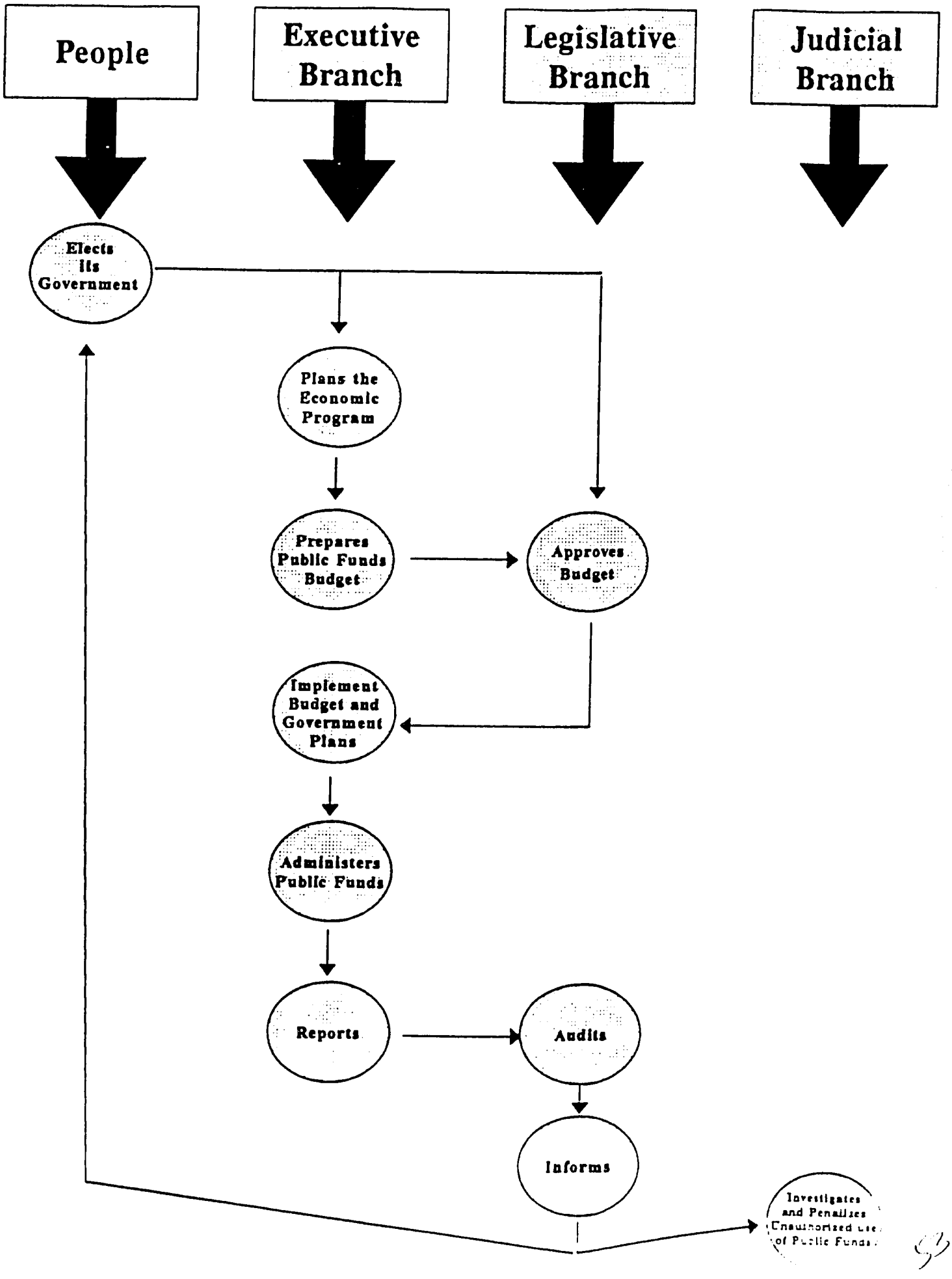
Improved integrated financial management contributes to both higher economic performance and the strengthening of democracy. Better financial management practices and tighter government auditing will strengthen public confidence in the transparency of public administration. Such improvements, accompanied by public dissemination of the results of government financial performance, will enable greater vigilance of public affairs by the Salvadoran people. This will empower the populace by giving them the information necessary to allow for an informed basis of judgement to sustain a regular transfer of power in a popularly elected civil society. Improved integrated financial management will raise accountability of public officials, reducing corruption, fraud and mismanagement. In addition, more timely, accurate and usable information on government financial accounts will permit more effective allocation of scarce public resources. This will lead to improved provision of basic social services and increased efficiency of public investment.

Based on the above, and on the premise that ultimately the inability of government officials to respond publicly on how they have administered public resources will lead to distrust or disillusionment with a specific government and perhaps the democratic process in general, the GOES and USAID/EL SALVADOR have jointly embarked upon an aggressive strategy to strengthen public accountability. This is a key element in the Mission's overall strategy to support the peace process and promote an enduring democracy in EL Salvador.

The relationship between accountability and democracy is illustrated graphically in the next page. As shown in this chart, accountability is an integral part of the entire democratic process. Based on information generated by a functioning democratic process a nation's citizens elect members of the executive and legislative branches of government. Accountability helps to maintain a proper balance between these elements. The Executive branch administers and executes the programs of government. The Legislative branch represents the general populace by approving the Executive's budget request and by conducting independent audits. Information generated by independent audits enables both the Legislative and Executive branches to make adjustments necessary to assure that government resources are being used efficiently or results when necessary in referrals to the Judicial branch. The Judicial branch enforces accountability by carrying out civil and criminal prosecutions against elected or appointed officials who fail to respect the public trust.

The vehicle to promote public accountability is the implementation of a modernized Integrated Financial Management system with an independent legislative auditor to provide for an independent review and public report on the effectiveness of government operations. One by-product of the increase in public accountability will be increased economic growth as the government improves its ability to allocate limited resources to the different sectors of society. A second by-product of improvements in public accountability generated by implementation of a modernized Integrated Financial Management system will be less opportunity for corruption.

Financial Responsibilities in a Democracy



Since assuming power in June 1989, the current GOES has demonstrated a solid commitment to improving public accountability through the modernization and upgrading of its public finances. In his inaugural address President Cristiani stated that one of his principal objectives would be to eliminate the scourge of corruption and administer with absolute propriety public funds and property. A series of administrative weaknesses in public sector accountability which would impact upon the GOES' ability to effectively deliver public services were identified. Accordingly, early in the administration the GOES requested external assistance from the International Monetary Fund, the Inter-American Development Bank and AID to implement a new governmental accounting system and modernize their tax practices. In May 1990, President Cristiani, specifically stated that it was necessary ... "to initiate efforts to try to give the Court of Accounts of the Republic (the GOES supreme audit agency) the legal, institutional and material instruments that modern systems of government control require." In 1991-92 a high level GOES committee developed a comprehensive strategy to improve integrated public sector accountability and auditing. The proposed FY 1993 ESF program provides continued support to deepen GOES efforts in this area.

B. Background

While other countries in Latin America, most notably, Chile, Bolivia, Ecuador and Panama have made significant improvements in their public sector accountability practices, El Salvador's 12-year civil war has impeded such progress. Consequently, the GOES public sector accountability system is still quite antiquated. For example, El Salvador is one of the few Latin American countries that still cling to the practice of disbursement pre-approval by an external agency (the Court of Accounts) instead of relying on decentralized internal control systems and an effective independent ex-post audit process. The Court of Accounts is required by constitutional order to oversee and validate all expenditures of the Central Government. This pre-validation process by a centralized entity rather than by the implementing agencies results in delays in the disbursement process, dissipates responsibility, compromises the independence of the Court of Accounts and does not provide adequate control of the use of funds, thus permitting graft and corruption. These and other public sector financial management deficiencies have had a negative impact on the GOES' ability to foster economic development.

Modernization of the GOES public sector accountability system to help the GOES make better use of its own and external resources is an area of mutual concern between the GOES, AID, the IMF, the IDB and the World Bank. Several Mission-funded studies have pointed out the need for changes in the GOES' public sector accountability system and recommended assistance in developing an improved integrated financial management system. In January 1992 at an informal donors conference sponsored by the World Bank, donor representatives emphasized the importance of improved public finances in El Salvador and coordinated their activities to support the GOES in its public sector accountability modernization program. The program proposed in this concept paper will help support these efforts.

C. Progress to Date

Since 1991, supported by the ESF conditionality and AID-funded technical assistance, the GOES has made notable progress toward improving its public sector accountability and auditing systems. In 1991, the GOES established a committee consisting of the Minister of Finance, the Minister of Planning and the President of the Court of Accounts, supported by a technical group, to assess the status of GOES public sector accountability. In 1992 the committee developed a strategic plan of action for the implementation of an integrated accountability and auditing system in the public sector. The strategy consisted of two parts: one, contracting of a USAID-funded international consultant to assist the Court of Accounts in developing post-audit capability; and, two, procuring of the services of an institutional contractor to provide technical assistance to the Ministry of Finance in the areas of budgeting, treasury, public debt, accounting and management information systems. In October 1992 the Mission contracted an auditing consultant for the Court of Accounts. The Mission awarded a contract in February 1993 for a technical assistance package to further support GOES efforts to implement part two within the Ministry of Finance.

In 1992 the GOES presented an interim organic law for the Court of Accounts to the Legislative Assembly. The law represents a major interim step toward converting the Court of Accounts from an exclusively expenditure pre-control agency to an ex-post audit agency. While the proposed law substantially strengthens the post-audit function, due to existing Constitutional requirements, it also continues to maintain some pre-control on spending. Full elimination of the pre-control function will require a Constitutional amendment which must be approved by two consecutive Legislative Assemblies. Thus, even with approval of the current Assembly, a Constitutional amendment could not go into effect until after the next Legislative Assembly is seated in May 1994.

The above underscores the importance of another major interim step toward eventual full elimination of the pre-control function. On July 30, 1992, the Legislative Assembly approved Legislative Decree 302, "Documentation for Advance of Funds", which does away with external pre-control on an individual transaction basis and allows the Ministry of Finance to set up decentralized paying offices to improve payment processing time. The GOES also developed an action plan for auditing GOES financial statements, generated a series of new internal regulations to speed up payment processing, and negotiated new contracts with banks to reduce the time banks may retain government receipts before forwarding them to the Treasury. In 1992 the GOES conducted a review of existing laws on budgeting and treasury operations and developed an action plan to modernize such laws.

The most significant achievement in public sector accountability in the last two years has been the design of a new governmental accounting system. With technical assistance provided by the IMF, a new accounting law for the Central Government, decentralized agencies and municipalities was approved by the Legislative Assembly in December 1991. This new law replaces a previous one dating from the early 1950s, establishes a new chart of accounts, prescribes minimum qualifications for government financial officials, and

provides for periodic training courses to maintain qualifications. It also establishes sanctions for failing to perform duties responsibly. The new accounting system is now being implemented on a trial basis in four GOES agencies. Full implementation is expected to begin in January 1994.

The actual success of all measures taken to date to improve public accountability will depend, however, on the final definitive resolution of the Court of Accounts problem by the passage of a Constitutional amendment to redefine the role of the Court of Accounts. This Constitutional amendment should eliminate the external pre-control function now exercised by the Court of Accounts, establish an independent auditor general's office and transfer to the judiciary many of the incompatible judicial functions now performed by the Court of Accounts.

In an effort to overcome this last major obstacle to public accountability four members of GOES National Assembly traveled to Bolivia in February 1993 to determine how the GOES should proceed. Bolivia was selected as a country worthy of study because it has recently gone through a similar process of eliminating pre-control and establishing an auditor general's office. Both Bolivia and El Salvador have approximately the same population size and both have had similar experiences in trying to reestablish democracies in the 1980s. The commission that traveled consisted of the President of the National Assembly, one of the Vice-Presidents of the National Assembly and two other legislators. It is noteworthy that the commission that traveled to Bolivia included legislators from each of the four major political parties. Upon their return from Bolivia, the Salvadoran congressman held a joint press conference in which they unanimously indicated it was now time to improve public accountability by preparing a Constitutional amendment to modify the role and function of the Court of Accounts. A commission to draft the proposed amendment was formed on March 1, 1993. The GOES needs USG support to continue with this reform. If this amendment can be presented to this Assembly in 1993 there is a good chance it can become effective in 1994. If the proposed amendment slips beyond the current Assembly according to Salvadoran law it could not possibly be effective before 1997.

VI - PROPOSED FY 1993 ESF PROGRAM

A. Program Objectives

Shortly after its inauguration in 1989, the Cristiani Administration began to implement a set of comprehensive and coherent economic policies with the purpose of restoring financial stability and establishing a policy framework that would promote sustainable economic growth. The measures implemented during the past three and a half years are described in Chapter II. At this point, the challenges are to improve the fiscal situation; to avoid economic policy reversals, particularly as national elections near; and to conclude a number of policy reforms initiated during 1992. Maintenance and deepening of economic policies is expected to continue to have a highly positive effect on GDP growth. **Increasing equitable and sustainable economic growth is the first objective of the 1993 ESF Program.**

A lasting peace in El Salvador depends on full and timely implementation of the agreements under the Peace Accords, many of them related to the strengthening of key democratic institutions. These agreements call for, inter-alia, the establishment of a national civilian police, electoral reforms to facilitate citizen participation and build greater credibility in the electoral process, labor-government-private sector collaboration in the development of a new labor code as a basis for guaranteeing basic labor rights embodied in the 1983 Constitution and international agreements, and measures to achieve greater independence of the judiciary from political interests. Consolidation of the peace requires that the population at large, and particularly opposition groups, have meaningful access to the political process and confidence in the justice system as a fair, impartial arbiter when conflicts arise. Great progress has been made to date in implementing the Peace Accords. Notwithstanding these advances, however, the support of the international community, and specifically the United States, for a deepening of the judicial reform process will continue to be critical for maintaining reform momentum during the highly charged period leading up to the March 1994 national elections. **Continued support for strengthening democratic institutions, processes and procedures is the second objective of the 1993 ESF Program.**

The GOES, with Mission support, has embarked on a strategy to improve public sector financial management. Improved financial management and the development of a new sense of public accountability which provides for the full disclosure of how government officials have utilized public funds are essential components of a democracy, and will contribute to the preservation of the peace. Improved financial practices will also help the GOES to better allocate fiscal resources, and therefore permit an increase in the quantity and quality of public services. **Continued support for improved integrated financial management and auditing practices and procedures is the third objective of the FY 1993 Program.**

B. Proposed Conditionality Measures

This section provides the rationale for the policy reforms that will be

supported by the proposed FY 1993 ESF Economic and Democratic Support Program. Given the high impact derived from policy changes, the Mission is choosing to attribute various congressionally-mandated earmarks to this program. The level and type of earmark will appear in parenthesis next to the appropriate section. A matrix presenting a tentative listing of specific measures is included in the Summary and Conclusions (Section I), at the beginning of this Concept Paper.

1. Objective: Consolidate Sustainable Economic Growth

a. Improve Fiscal Performance

The fiscal situation deteriorated markedly after the first half of 1992, marking the most significant deviation from exemplary economic management. Although the tax ratio (taxes as a percent of the GDP) has increased since 1989, this increase has not been sufficient to compensate for rising expenditures, some of them associated with the peace process and the National Reconstruction Program. Measures to improve fiscal performance are necessary to get the economic program back on track.

(i) Increase the Efficiency of the Electricity Sector ($6.5 million for energy/environment earmark)

Public utility rates are presently established by executive decree of the Ministry of Economy. This process is highly politicized, not transparent, and intrinsically undemocratic. The establishment of an independent public utility commission could depoliticize the process. By decentralizing power and increasing information to the general public, it would strengthen democracy. In the meantime, the country needs to develop an interim plan for rationalizing its electricity tariffs. Such a plan could be developed immediately and its implementation begun long before a suitable regulatory commission could be set up and begin functioning. About 220,000 electricity users have no meters and are charged a flat fee based on an estimate of consumption. This discourages energy conservation and may foster corruption. The preparation of a plan to reduce the electric meter deficit was a condition of the second disbursement of 1992 ESF. CEL has ordered 250,000 new meters (with USAID financing) and expects to gradually reduce the meter deficit over the next 20 months and eliminate it by December 1994.

The key measures that address these issues are:

- Present to the Legislative Assembly/make good faith effort to gain approval of legislation establishing an independent electricity rate commission;
- Prepare plan for raising electricity rates toward long-run marginal costs.
- Achieve satisfactory progress on the installation of electricity meters, particularly for commercial and industrial users;

58

(ii). Improve Tax/Customs Administration

A number of improvements in customs operations could substantially improve revenue collections while ensuring fairer treatment of importers. For instance an AID-financed technical assistance project is installing a computer-based valuation and data system, which will help to substantially close the gap between customs valuations of goods and their true market values. This computer-based system, along with classification training and general improvements in customs procedures, could possibly raise revenues by 25 percent, or ₡200 million over base, and will help reduce corruption. These same improvements would raise about an additional ₡170 million in value-added tax (VAT) revenues, since about 40 percent of the VAT is presently collected at customs.

Penalties for tax evasion are minimal, consisting mostly of insignificant fines (the maximum fine for income tax evasion is ₡9,000, or about $1,000). The recently enacted Value-Added Tax law included a number of articles establishing stiff penalties for evasion, including the closure of businesses, but some of those articles were declared unconstitutional by the Supreme Court because it was considered that they denied offenders their due process. It is necessary to draft a code with strict and enforceable penalties for tax evasion that respects constitutional precepts. In Mexico, passage of a similar code change, together with well publicized arrests of only a few tax evaders, resulted in an increase of 40 percent in income tax revenues. In El Salvador, a rough estimate is that increased penalties for tax evasion could have similar results.

The key measures to address those issues are:

- Prepare updated customs reform plan and demonstrate progress in implementing it; and
- Demonstrate satisfactory progress in implementing tax modernization program including increasing from 600 to 1,000 the number of taxpayers monitored by the Large Taxpayers Unit.
- Submit/demonstrate good faith effort to gain Legislative Assembly approval of law to make tax offenses criminal acts.

(iii) Reduce Role of the State

Privatization can increase efficiency and can also contribute to a reduction of the 1993 deficit. The most significant revenue measure proposed to close the fiscal gap in 1993 is the sale of government assets valued at ₡130 million ($14 million).

During the 1980s, the share of wages in total central government expenditures increased sharply from 38 percent in 1981 to 55 percent by 1989. Since then, the wage share has declined continuously and is to be only 43 percent in 1993. Contributing to this drop were restraints on salary hikes and a government-wide hiring freeze. In 1992, approximately 15,000 public employees resigned under voluntary separation programs. About

two/thirds of the positions vacated under these programs, were not to be refilled. In late 1992, over two thousand of the positions vacated were formally frozen (eliminated). The GOES has indicated its commitment to formally freeze an additional 4,000 during 1993.

The key measures in this area are:

-- Privatization of ___ entities. The exact number is being discussed with the GOES.

-- Maintain a restrictive public sector employment policy, including the freezing of 4,000 recently vacated positions.

b. Promote Improved Governance Through Decentralization

The decentralization of authority from the central government to the municipalities is a stated GOES objective. In his September 1992 address to the nation's mayors, President Cristiani clearly stated his support for the efforts of the Organization of Mayors of El Salvador (COMURES) and the Salvadoran Institute of Municipal Development (ISDEM). Subsequently, a high-level and technical committee composed of COMURES, ISDEM, and the Ministry of Planning was formed for the purpose of developing a strategy for decentralization and municipal development and to elaborate an action plan for its implementation. In addition, the GOES has demonstrated its commitment to decentralization through its support for the strengthening of ISDEM, the revitalization of COMURES, expansion of the Mayors in Action Program (MEA), and the passage of legislation permitting local governments to charge user fees for certain local services. Various actions taken by and on behalf of municipalities include: analysis of problems in municipal budgeting and accounting, training in 32 municipalities in financial management, implementation of user charges, and preparation in several jurisdictions of municipal property rolls. In addition, the Mission is designing a technical assistance and training package (Municipal Development Project) to strengthen the capacity of municipalities to more effectively and efficiently manage the financial, administrative, and technical aspects of municipal development.

An increase in municipal control over local affairs must be accompanied by increased revenues if local governments are to finance the expansion of services and responsibilities. While El Salvador does have a very progressive municipal code in many respects, it does not provide the necessary authority to raise significant revenues at the local level. In many countries throughout the world, the local property tax is the principal source of municipal revenues. A property tax can: 1) produce large revenues; 2) finance the delivery of some services more efficiently than centralized entities, and 3) decrease the need to rely on central government transfers and other donations.

The introduction of enabling legislation for a property tax is a feasible and necessary step toward further decentralization in El Salvador. Specific conditionality for this measure is being negotiated with the GOES.

One option being discussed is enabling legislation which will allow the municipalities the option of implementing the tax. On the heels of the VAT, this should be far more politically palatable than a mandatory property tax law. While currently only a limited number of municipalities are in a position to implement a property tax, USAID anticipates a gradual phase-in with the assistance of the AID Municipal Development Project scheduled as a new start later this year.

c. Improve Financial Intermediation

Before the financial sector reforms, the commercial banking system was essentially state-owned and interest rates were regulated. In 1991 and 1992, the financial sector was deregulated significantly, controls on interest rates were eliminated, three of five state-owned banks were privatized, and the process for selling two more is proceeding. The financial institutions organic law stipulated that new banks could not be established until June 1993. Reducing barriers to entry after that date would tend to increase the efficiency of the banking system, and would make it more difficult for a small number of individuals to control the banking sector. The continued success of financial sector liberalization will depend on the ability of the Superintendency to carry out adequate prudential supervision of the financial system. This will require further improvements in legislation, and an adequate budget for the Superintendency.

Commercial banks, before they were privatized, had a significant proportion of non-performing loans in their portfolio. Before privatizing the banks, the Central Bank cleaned up their portfolio, and essentially assumed the accumulated losses. The non-performing assets are now held by the Financial Restructuring and Strengthening Fund (FOSAFFI), and there is a need to collect on those bad loans, thus strengthening the financial position of the Central Bank. At present, FOSAFFI has no authority to discount debt, and this is a major legal impediment to debt collection. While the Central Bank clearly does not want to send a message to debtors that bad loans will be forgiven, it is unlikely that more than 20 percent of the ₡1.7 billion FOSAFFI bad debt portfolio will be collected. FOSAFFI is currently examining the viability of its operations, but it is clear that it needs legal authority to negotiate bad debt collections using a range of flexible approaches.

A large number of the bad loans were issued by the Banco Agrícola Comercial. In 1991 a series of indictments were issued by El Salvador's Attorney General to some borrowers in an effort to accelerate loan repayments. Section 530(e)(2)(B) of the FY 1993 foreign assistance appropriations bill requires that, ..."of the FY 1993 ESF allocated for El Salvador, $20 million be withheld from expenditure until 15 days after receipt by the Appropriations Committee of a report from the Secretary of State which describes and assesses the efforts being made by the GOES to collect on loans made by the Banco Agrícola Comercial which were the subject of indictments issued during 1991."

The Central Bank, partly as a result of the cleaning up of the portfolio of commercial banks, incurred losses. The IMF estimated that these losses were, on a cash basis, the equivalent of 0.8 percent of GDP. The

elimination of these losses will contribute to financial stability, but it will require resource transfers from the central government.

The key measures that address these issues are:

- Develop, approve and announce procedures for establishing new banks, both domestic and foreign; and demonstrate that there are no restrictions to the establishment of new banks;
- Implement plan to strengthen the Superintendency of the Financial System;
- Draft modifications to current legislation/demonstrate good faith effort to gain legislative approval of modifications to current legislation to improve bank supervision;
- Formulate/implement a plan for recovery of past-due loans of FOSAFFI, including Banco Agrícola;
- Complete the preparation of a plan to reduce Central Bank losses.

d. Promote Exports and Further Deepen Trade Liberalization

El Salvador initiated a rapid trade liberalization program in 1989, reducing nominal tariffs to a maximum of 20 percent, with a few exceptions for luxury goods and textile products (maximum rate for those products is 30 percent), and establishing a minimum tariff of 5 percent. El Salvador undoubtedly has been the leading country in trade liberalization in Central America. The present challenge is to deepen trade liberalization through additional reductions in effective protection and by the elimination of all remaining barriers to the free movement of goods and services. Given that the most obvious barriers to trade have been eliminated, there is a need to carry out a study to identify the additional measures that must be implemented. AID will provide technical assistance to carry out this study, and the development of the terms of reference will be coordinated closely with the World Bank.

Some state-owned enterprises import goods without paying duties. The elimination of these exemptions will level the playing field between the public and private sector.

The key measures to address these issues are:

- Complete study of policy measures/implement policy measures required to deepen trade liberalization and prepare a strategy to promote exports. Implement the recommendations of the study.

- Submit/demonstrate good faith effort to gain legislative approval of law eliminating all remaining tariff exemptions for CEL, ANDA and ANTEL for imports financed with domestic resources.

e. Maintain Adequate Macroeconomic Framework and Structural/Sector Adjustment Policies

The maintenance of an adequate macroeconomic framework is absolutely necessary to guarantee the success of all the policy measures described above. While the lead institution in the stabilization area is the IMF, and the lead institutions in the structural/sector adjustment areas are the IBRD and the IDB, ESF conditionality can provide decisive additional leverage.

The key measure to address these issues is:

-- Adhere to economic program targets.

f. Rationalize Public Education and Health Spending ($1.8 million for education earmark)

Public health facilities, such as hospitals and clinics, receive the overwhelming share of their financing from central government financing. Indeed, user fees only cover about two percent of the costs of providing services. By raising user fees central government transfers could be more directly targeted to true public health concerns. In addition, raising user fees would better allocate public health resources between those who want specific services and are willing to pay while ensuring that the most basic services remain available to those in need but unable to pay. A pilot plan for increasing cost recovery in the health sector is being developed.

The purpose of the AID supported SABE project is to increase the efficiency and quality of primary education. At present, the project finances inputs essential for quality and efficiency, namely educational material and teacher training. These are current expenditures, and eventually must be financed by GOES budget resources.

The key measures to address these issues in 1993 are:

— To improve the quality of health services, initiate a pilot program to increase cost recovery and develop a strategy to extend the pilot program.

— Conditionality on resource allocation in the basic education sector is being developed and negotiated with the GOES.

Education and health sector assessments are being conducted this year. Based on recommendations resulting from those assessments, the Mission will formulate more specific conditionality for education and health sector reforms to be supported by the FY 1994 ESF program.

g. Improve Quality of the Environment
($1.7 million for energy/environment earmark)

Without mineral or petroleum resources, El Salvador is totally

dependent upon renewable natural resources for income generation in productive sectors including agriculture, forestry and fisheries, and the supply of raw materials to manufacturing and processing industries. The combined impact of population pressures and entrenched poverty is mainly responsible for the over-exploitation of natural resources. Parallel to the above constraints are the more controllable factors of inadequate and unenforced policies and standards for environmental protection. As a consequence, the depletion rates of soil, water, forests, fisheries and other resources exceed their renewal rates. There is a need to develop a plan to improve the quality of the environment. The AID-financed PROMESA project can assist in the formulation of that plan.

Measure supported in this area is:

-- Demonstrate satisfactory progress in the development of a national strategy for the protection of the environment and for the management of natural resources. Demonstrate satisfactory progress in the implementation of financing of the national strategy.

h. Improve Investment Climate

The GOES has made notable progress towards increasing incentives for domestic and foreign investment. Improved investor confidence is evidenced by recent increases in private investment. In 1992, agreement was reached on the terms to resolve an investment dispute with international investors, but final payment has not been made.

Proposed measure in this area is:

-- Resolve outstanding investment dispute.

2. Objective: Strengthen Democratic Practices, Processes and Procedures

a. Improve the Administration of Justice

Justice sector reform has entered a critical phase. The momentum achieved in recent years through Constitutional reforms enacted in late 1991, the investigation and prosecution of military officers and the economic elite for criminal acts, and the legal reform efforts and educational programs that have built a modest but growing base of support for further reform, could be easily lost if additional tangible signs of change are not soon evident. Key among these changes are measures designed to depoliticize the judicial appointment process, such as reforms to the National Council on the Judiciary (NCJ) -- the body responsible for screening and nominating candidates for judicial appointment -- and the judicial career law. Both reforms were recently approved and must now be implemented. The GOES must ensure that adequate financial resources are allocated to the MOJ to provide for operational independence and adequate technical capacity to discharge its responsibilities. Legal reforms, focussed on the protection of individual rights, as well as institutional strengthening programs for the prosecutors

and public defenders, to ensure that both individual and the state's interests are adequately protected, must also be continued to provide the foundation of a legal system that respects individual rights and affords all citizens access to speedy, impartial justice. While progress was made in reducing military control of the Special Investigative Unit (SIU), its complete civilianization would represent an important democratic initiative.

Measures included in the 1993 ESF policy reform program are focussed on maintaining momentum for justice sector reform, and include:

-- Carry out and implement recommendations of a study(ies) on organizational effectiveness and operational needs of the Public Ministry;

-- Adequate progress in implementing the national legal reform program; and

-- Completion of the civilianization of the Special Investigative Unit.

b. Support Fair and Free Elections

The Presidency, National Assembly seats, and local government offices will all be contested in the 1994 elections. As the first peacetime election since the 1970s, they will be a critical test of the success of reconciliation efforts and the durability of democracy in El Salvador. Although eight successive elections have been judged fair and free by outside observers, complaints by political parties and citizens over the failure of the Electoral Tribunal to issue voting cards (carnets) in a timely manner have marred an otherwise impressive record, given the constraints of a civil war. A principal constraint in the timely issuance of carnets has been the inability of citizens to prove their citizenship through presentation of the personal identification and birth certificate provided by the municipality, and the corresponding inability of the Tribunal to verify information provided by individuals through communication with municipalities. Municipal records in over 100 municipalities were destroyed during the twelve-year conflict, leaving an estimated 500,000 to 1,000,000 Salvadorans currently "undocumented." A recently passed law is facilitating the reconstruction of municipal records, and the issuance of birth certificates and citizen personal identification (cédulas). The possession of a cédula will enable an individual to obtain his/her voting carnet.

A second concern, which in previous elections delayed issuance of voting cards and election preparations, is an inadequate level and late provision of financial support for the Elections Tribunal.

Measures included in the FY 1993 ESF program are:

-- Ensure the timely disbursement of funds to the Supreme Electoral Tribunal for preparation for the national elections of 1994;

-- Submit to the Legislative Assembly the extraordinary budget for the Supreme Electoral Tribunal (SET) to obtain the funds necessary for the 1994 national elections, and ensure the timely disbursement of the funds.

-- Satisfactory progress in the reestablishment of civil registry and citizen documentation in ex-conflictive zones to facilitate citizen participation in 1994 elections.

-- Complete implementation of plan of the Salvadoran Institute for Municipal Development (ISDEM) for the reestablishment of civil registry and citizen documentation in ex-conflictive zones to facilitate citizen participation in national elections of 1994.

c. Promote Respect for Worker Rights

The existing labor code requires revision to provide adequate legal protection of basic rights afforded workers in the 1983 Constitution of El Salvador and worker rights such as the right to organize, strike and bargain collectively. Moreover, there is a need to improve the Ministry of Labor's procedures with regard to the registration of unions and the Government's ability to apply and enforce labor legislation concerning workers rights.

The Social and Economic Forum, created pursuant to the Peace Accords as a tri-partite forum (labor, government, and business), is to serve as a vehicle for debate and consensus building on a new code. Labor concerns over short-term measures needed to alleviate the adverse impact of the economic adjustment program on the poor prevented priority being accorded to the labor code during 1992. However, in February 1993, the GOES, labor leaders, and private sector representatives who are members of the Forum reached agreement on overall principles and concrete actions to improve worker rights in El Salvador. This "Social Pact" provides for the reaching of consensus on a new labor code by September 30, 1993.

Measures proposed for the FY 1993 ESF program are designed to support progress by the GOES in promoting worker rights, and include:

-- Meet the targets agreed in the Foro on the "Social Pact" ("Acuerdo de Principios y Compromisos"). Conditionality for the second disbursement is still being developed and negotiated with GOES.

-- Development by the GOES, in consultation with labor leaders and the private sector, of a plan to improve the application and enforcement of worker rights, and subsequent implementation.

3. Objective: Strengthen Integrated Financial Management and Auditing

a. Increase Accountability for the Use of Public Resources

In 1939, to reduce corruption in El Salvador, Article 195 was incorporated into the Constitution to establish an independent Court of Accounts to review prior to execution every action which would result in the disbursement of public funds. While pre-validation of funding activities is an appropriate internal control mechanism when exercised by an implementing agency, it is an ineffective mechanism when carried out by a centralized agency such as the Court of Accounts. Court of Accounts officials who exercise pre-control are not integrated into the hierarchy of the agency over which they are exercising control and are not accountable for the decisions they make or actions they take. In this way external pre-controls may actually contribute to corruption rather than to its reduction. Legislative Decree 302 approved by the Legislative Assembly on July 30, 1992 and the interim organic law submitted to the Assembly to meet the conditionality requirements for the 1992 ESF program are beginning to reduce the negative effects of pre-control but have not eliminated them. To build accountability into the GOES financial management system, a Constitutional amendment is required to move the pre-control function to each implementing agency, making each Ministry responsible for its actions.

The second part of the proposed Constitutional amendment is to create a truly independent supreme audit organization. The interim organic law presented to the Legislative Assembly in October 1992 recognizes and authorizes the Court of Accounts mandate to do audits, but until a Constitutional amendment is approved and ratified, the Court of Accounts will be placed in the dubious position of auditing and expressing an opinion on actions which it had previously approved and authorized. This conflict of interest violates the independence concept of internationally recognized audit standards and precludes AID from accepting any work performed by the Court of Accounts under the Recipient Contracted Audit program administered by AID's Office of the Inspector General.

In addition to pre-validation of spending, the Constitution also authorizes the Court of Accounts to ensure accurate revenues collection. The Court of Accounts has chosen to exercise this authority only in the area of import duties. Court of Accounts participation in import classification, valuation and imposition of duties introduces unnecessary bureaucracy, provides greater opportunities for corruption and hampers the GOES' attempts to reform and professionalize the Customs Service.

To remove the conflict of interest that is embodied in the Court of Accounts participation in Customs operations, the Constitution needs to be amended to remove the authorization for the Court of Accounts' control over revenue collection and future control by the Court of Accounts must be limited to ex-post investigations.

While there is growing support in El Salvador for a Constitutional amendment to eliminate the pre-control function of the Court of

Accounts, amending the Constitution is a highly political issue for two main reasons. First, since the new Constitution was approved in 1983, it has been amended only as part of the peace process, and a new amendment related to the Court of Accounts could set the precedent that the Constitution can be amended often. Second, a formal link between an ESF disbursement and a Constitutional amendment could be politically unacceptable.

Cumbersome processes for disbursing public funds is a major factor in delaying the implementation of donor-financed projects. In 1983, the Secretaría Técnica del Financiamiento Externo (SETEFE) was created with AID support to handle donor resources (the "extraordinary budget"). While SETEFE offered an interim solution, it also created other problems, including: the extraordinary budget is not reviewed by the Legislative Assembly; it is difficult to determine the total amount of spending (ordinary plus extraordinary) which go to particular activities; and disbursements from SETEFE often are carried out with minimal coordination with the Central Bank, thus making monetary management very difficult. The World Bank SAL I required that steps be taken to unify the two budgets, and in 1992 the data for both budgets for 1993 were presented in a way in which it is possible to add both budgets in order to get total spending for the year. While this represents some progress, only the ordinary budget was submitted to the Legislative Assembly for approval.

Proposed measures to improve accountability are:

— Conditionality on the Court of Accounts is being developed and negotiated with the GOES.

— Demonstrate satisfactory progress in implementing GOES commitment to budget unification.

— Demonstrate progress in implementing action plan to improve integrated financial management.

b. Improve Public Sector Cash Management

Firms and individuals providing goods and services to public sector institutions must wait for payment up to eleven months. This discriminates against those with limited working capital and/or access to credit, and it increases public sector expenditures as vendors charge higher prices to government institutions. In 1992, some progress was made in reducing the time required for processing payments at the Ministry of Finance, but the period of time between delivery of a good or service and actual payment remains inordinately long.

Proposed measure to resolve this is:

— Conditionality on prompt payment measure is being developed and negotiated with the GOES.

C. Dollar Resources

1. Cash Transfer vs. CIP

The cash transfer has been selected over the commodity import program (CIP) as the most appropriate mode of ESF non-project assistance for El Salvador in 1993. The need for quick-disbursing, flexible assistance, especially given the particular needs of the GOES in funding institutions associated with the peace process, requires the use of the cash transfer mechanism since it generates HCOLC immediately. Furthermore, the existence of El Salvador's fully liberalized, market-determined exchange rate regime makes the CIP option impractical and counter-productive. Importers would find the CIP costlier than importing through normal commercial channels. Thus, in order to move the CIP, a preferential exchange rate would have to be created. This would result in undesirable subsidies to the private sector while also causing the reestablishment of a multiple exchange rate regime. Under its IMF stand-by arrangement, the GOES has pledged not to reintroduce multiple-exchange-rate practices.

The use of the cash transfer mode is critical to the achievement of the proposed program's objectives discussed above. The thrust of the program is to encourage maintenance and adoption of critical economic and democratic reform measures during 1993. This will require effective leverage. In order to maximize the leverage of the ESF available for the program, the cash transfer mode should be used as GOES officials perceive ESF in that form to be of greater value than the same amount of ESF through a CIP. In fact, a CIP has never been used in El Salvador. Thus CIP start-up costs in terms of both Mission management time and policy-dialogue capital would be high and therefore limit the effectiveness of the proposed policy reform support program.

2. Use of Dollars

The Mission proposes two $35 million disbursements linked to satisfactory GOES performance on the policy reform measures discussed above. The first disbursement is programmed for July based on GOES performance on policy reforms and measures scheduled to be completed by June. The second disbursement is programmed for November based on GOES performance on actions to be completed by October. Disbursements made according to this proposed schedule are sufficient to encourage policy reforms while appropriately spreading out the financial impact of the cash transfer.

Separate Dollar Account: The Mission will continue to follow the separate dollar account procedures developed for its FY 1991 and FY 1992 ESF cash transfer programs.

Under the cash transfer mechanism, the dollars made available through the program, plus interest generated by such funds, will be used to liquidate import transactions of the private sector for raw materials, intermediate goods, capital goods, spare parts, agricultural inputs, petroleum and petroleum derivatives from the United States. Imports to be liquidated against the Program will be for the use of the private sector of the

Salvadoran economy in the manufacturing, agricultural, agroindustrial, commercial, construction, transportation, communications, energy and services subsectors.

The Central Reserve Bank's price checking unit, initially established with USAID-financed technical assistance to verify prices of merchandise imports financed under the ESF program, was terminated in FY 1991 with AID/W concurrence (91 STATE LOU 077620). The price checking unit performed an important function under El Salvador's previous overvalued fixed exchange rate regime where it served to limit the overinvoicing of imports, and it helped prevent unauthorized access to foreign exchange at preferential rates. Under El Salvador's current flexible, market-determined system, the exchange rate varies with supply and demand, and there are no preferential rates. Therefore, the incentive to engage in overinvoicing of imports to obtain additional foreign exchange at preferential rates has disappeared. As long as El Salvador maintains its flexible exchange rate regime, the Mission sees no need to resume price checking operations.

D. Local Currency Resources — Programming Issues

1. Background

Local currency resources generated from ESF Policy Reform dollars continue to play a crucial role in Mission efforts to foster broad-based economic growth; support evolution of a stable, democratic society; and facilitate international cooperation in addressing specific challenges. ESF local currencies have financed activities in five areas: (1) counterpart for AID projects; (2) specific GOES/Mission high-priority activities such as the NGO support fund and municipal development projects; (3) general budget support to GOES development Ministries, such as health, education and agriculture, and counterpart for other donor projects in those Ministries; (4) AID OE trust funds; and (5) AID program trust funds.

As noted in previous PAADs, the Mission undertook significant management and quality reforms in the local currency program. While in effect now for two years, the reform program has demonstrated positive results, and the Mission has reported clearer impact data related to our five strategic objectives and greater efficiencies in implementation. In particular, the revised format for the action plan for HCOLC use is more concise and more clearly identifies performance indicators. The number of new action plans has dropped almost 65 percent, and they more definitively target Mission and GOES objectives. Within USAID, the streamlined procedures have reduced the average review and approval period for new action plans from eight weeks to three. The GOES is increasingly taking the decision-making lead on financial reprogrammings and minor activity changes, thereby easing the burden on Mission staff. SETEFE implemented a strong audit and certification program, with well-defined scheduling benchmarks and a penalty system.

2. FY 1992 Program Update

The Mission applied the new local currency guidance (issued July

1991) to the generations accrued from the FY 92 dollar disbursements and will continue doing so for FY 93. Our current program either matches or surpasses the requirements in the policy guidance.

a. The General Assessment

In 1990, the Mission completed the General Assessment of Accountability and Vulnerability. It reported that the Mission had an overall medium to high level of confidence in the Technical Secretariat for External Financing (SETEFE), the special budgeting and financial management unit of the GOES established to manage AID funds. SETEFE, which manages the special account and the extraordinary budget, is generally recognized as a capable organization. The Mission works closely with SETEFE in all aspects of managing the local currency program: jointly programming local currency; approving action plans; tracking action plan goals, purposes and activities; reviewing program and financial reports; and participating in the audit programs. In the past three years, SETEFE has greatly strengthened its audit/accountability institutional focus and capacity. Reforms have taken place in implementing institutions, and are taking hold. This is evidenced by the substantial drop in fundings and questioned costs resulting from the audit of the CY 1991 program as compared to earlier years. While SETEFE is not a perfect institution, the Mission has a high level of confidence in its overall capabilities.

To further strengthen overall GOES, and particularly Ministry of Finance, financial management capabilities, the Mission and other donors have begun to implement a series of activities to modernize El Salvador's public finance system. USAID/El Salvador's efforts include provision of technical assistance and training to the Ministry of Finance and the Court of Accounts to improve and modernize the GOES' financial management and control systems. A description of the progress to date is summarized in Section V.C. of this document. A two-year technical assistance team has assisted the GOES in improving its tax system, and such changes as the value-added tax have been implemented.

b. Programming

The FY92 dollar disbursements generated local currency primarily for use in CY93. The Mission and GOES continued to program funds for the ordinary and extraordinary budgets, and OE and program trusts. Within the ordinary budget, the Mission selected the general budget (deficit) option.

The local currency program continued to support direct counterpart for ongoing AID DA projects through the extraordinary budget (extra-budgetary support). Following up on earlier decisions, the Mission generally did not program funds for counterpart to newly-authorized dollar projects or for GOES priority projects. The only exceptions to this policy were programming for the National Reconstruction Project, and for the Municipalities in Action Program, PVOs, and program administration/audit. This process has reduced the number of Mission management units and passed more authority and responsibility to the GOES, through the ordinary budget.

11

Mission plans for the trust fund corresponded to the levels approved by AID/W for operating expenses. The Mission also allocated funds through the program trust for the AIFLD-supported Salvadoran Labor Management Foundation (FOES).

c. Summary Table FY92 Program

		($ Millions)
Extraordinary Budget		55.0
AID Counterpart	34.0	
GOES Priority Projects	21.0	
Ordinary Budget		21.6
OE Trust Fund		3.6
Program Trust Fund		1.8
		82.0

3. FY 1993 Program

The local currency program will focus on activities supporting the Mission's five strategic objectives, while continuing to reduce management units.

a. Budget Unification

The GOES has taken steps to enact the unification of the extraordinary and ordinary budgets; however, the process has slowed recently. The Mission has encouraged the unification at all levels. Also, the World Bank has incorporated conditionality in its first structural adjustment loan (SAL I) to provide incentives for completing the process.

Thus far, a technical committee composed of high-level representatives from the Ministries of Finance and Planning and the Central Bank have met and produced a report proposing three options for unification. One option tends to favor Finance's position, the second favors Planning and the third is a compromise. The report was submitted to the Finance Committee of the Economic Cabinet, which includes the Ministers of Finance and Planning, and the President of the Central Bank. Due to the pressing priorities associated with the Peace Accords and the National Reconstruction Program, slower progress than expected has been made in recent months.

Nonetheless, at the technical level, some positive movement has taken place. The Ministry of Planning, through SETEFE, has adjusted internal procedures and paperwork to align with the ordinary budget, including the implementation of the new accounting system recently approved by the Legislative Assembly. Also, for the first time ever, the Executive Branch submitted both the extraordinary and ordinary budgets in the same package to the Legislature for CY 1993, although the extraordinary budget does not require legislative approval.

b. Programming

The FY93 local currency generations will be programmed to conform to this new system. The likely scenario is that the unified budget will have two components: operations and investment. The Mission and GOES will jointly program funds for counterpart to seven or eight dollar-financed programs and for two priority projects -- NGO support and program administration/audit. The GOES institution in charge will manage these funds through the investment side of the budget.

Given that the Mission's General Assessment of GOES/SETEFE Accountability and Vulnerability remains at a medium to high confidence level, we will continue to program funds for budget deficit reduction. This will be accomplished through the operations side of the budget.

The Mission will set aside funds for its operating expense trust fund in accordance with AID/W guidance. In addition, we will program an additional tranche of funds for the AIFLD-sponsored Salvadoran Labor Management Foundation.

c. Summary Table FY93 Program

		($ Millions)
Investment Component		35.0
AID Counterpart	33.0	
GOES Priority Projects	2.0	
Operations Component		28.0
OE Trust Fund		5.0
Program Trust Fund		2.0
		70.0

ANNEX A

EL SALVADOR: POLICY REFORM MATRIX — ALL DONORS

INSTITUTION	PROGRAM/DATE OF AGREEMENT AMOUNT	POLICY REFORM AREAS SUPPORTED	KEY MEASURES
A.I.D.	ESF Policy Reform CY 92 $82 million	Macroeconomic Program	Continued implementation of sound macroeconomic stabilization and structural adjustment program.
		Public Sector Efficiency	Improve tax policy and administration. Strengthen integrated financial management. Rationalize public sector employment.
		Investment	Improve private investment climate.
		Judicial Reform	Strengthen administration of justice.
	ESF Policy Reform CY 93 $70 million	Consolidate Sustainable Economic Growth	Continued implementation of sound macroeconomic stabilization and structural adjustment program.
			Improve fiscal performance.
			Improve financial intermediation.
			Tariff adjustments/elimination of duty exemptions.
			Rationalize public education and health expenditure.
		Strengthen Democratic Practices, Processes and Procedures	Improve the administration of justice. Support democratic institutions. Promote respect for internationally accepted worker rights.
		Strengthen Integrated Financial Management and Auditing	Increase accountability levels for the use of public resources. Improve public sector cash management.
		Enhance Environmental Quality	Strengthen institutional and legal framework.

ANNEX A

EL SALVADOR: POLICY REFORM MATRIX — ALL DONORS

INSTITUTION	PROGRAM/DATE OF AGREEMENT AMOUNT	POLICY REFORM AREAS SUPPORTED	KEY MEASURES
World Bank	SAL I 3/91 $75 million	Trade and Exchange Rate Policy	Market-determined exchange rate system. Tariff adjustments/elimination of exemptions.
		Fiscal Policy	Expansion of the tax base. Increased public sector savings. Strengthen tax administration. Improve taxation system equity. Introduction of the value-added tax.
		Interest Rate & Monetary Policy	Gradual elimination of interest rate controls. Reduced administrative credit allocation.
		Financial Sector Reform	Privatization of the Financial System. Strengthening of the Superintendency.
		Agriculture Sector	Elimination of price controls on basic grains.
		Social Sector	Social compensation programs for the poor. Improvements in social services quality, coverage and efficiency.
	SAL II $50-100 million	Public Expenditure Management	Strengthen expenditure planning and budget preparation. Reorganization of the Court of Accounts.
		Civil Service Reforms	Strengthening the capacity and reorganization of the Directorate of Ministry of Finance
		Tax Reform	Strengthen tax administration. Personnel Administration.
		Financial Sector Reform	Support capital markets development through improvements in its institutional and legal framework. Strengthen rural credit delivery system.

ANNEX A

EL SALVADOR: POLICY REFORM MATRIX — ALL DONORS

INSTITUTION	PROGRAM/DATE OF AGREEMENT AMOUNT	POLICY REFORM AREAS SUPPORTED	KEY MEASURES
World Bank (Cont)		Trade Reforms and Export Promotion	Strengthen trade policy legal framework. Tariff adjustments/elimination of duty exemptions.
		Social Sector Reforms	Support the institutionalization of community school programs. Support Ministry of Education reforms on budget and expenditure planning.
		Environmental Policy Reforms	Strengthening of legal and institutional framework.
	Social Sector Rehabilitation Project 6/91 $26 million	Basic Services Development Institutional Development	Delivery of nutritional assistance to the poor. Improve coverage and delivery of basic social services. Strengthen MOH and MOE planning and management capacity. Strengthen MIPLAN capacity to develop a social sector information system.
	Power Sector Project 9/91 $11 million	Sector Studies	Reforms on electricity pricing policy. Institutional and legal reforms. Privatization of power distribution.
		Engineering and Management Studies	Assessment of the management efficiency and organization of CEL.
		Acquisition of materials	Improve planning, systems reliability and electricity rate design.
		Training Program	Management development program.

ANNEX A

EL SALVADOR: POLICY REFORM MATRIX — ALL DONORS

INSTITUTION	PROGRAM/DATE OF AGREEMENT AMOUNT	POLICY REFORM AREAS SUPPORTED	KEY MEASURES
World Bank (cont)	PRISA CY 92 $60 million	Institutional Reform	Strengthen MAG planning and management capacity. Rationalize public sector agricultural expenditures.
		Privatization of Agricultural Enterprises and Services	Privatization of IRA.
		Research and Extension	Improve CENTA administrative and institutional capacity.
Inter-American Development Bank	Global Program of Multisectoral Credit 4/91 $60 million	Financial Sector Reform	Strengthening of the Financial System and the Superintendency.
	Investment Sector Loan 11/92 $90 million	Macroeconomic Framework	Continued implementation of a sound macroeconomic policies that will promote growth with price stability.
		Financial Sector Development	Support privatization of the financial system. Strengthening of the Superintendency. Maintain a market determined interest rate regime. Improve credit delivery mechanism for development finance. Strengthen capital markets institutional and legal framework. Support the development of the pension sector institutional and legal framework. Promote the development of the insurance sector.