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AGENCY FOR INTERNATIONAL DEVELOPMENT  
UNITED STATES OF AMERICA A. I. D. MISSION  
TO EL SALVADOR  
C/O AMERICAN EMBASSY.  
SAN SALVADOR, EL SALVADOR, C. A.

ACTION MEMORANDUM FOR THE MISSION DIRECTOR

TO: Kenneth C. Ellis, DIR

FROM: Mary C. Ott, Team Leader S01 *Mary C. Ott*

SUBJECT: Strategic Objective #1 Economic Policy Results Package (RP 5) "Economic Policy Environment Supporting Greater Equity"

**I. ACTION**

You are requested to formally approve the following:

1. Economic Policy Results Package at a funding level not to exceed \$45,183,000 for an expected duration of six years. This amount includes currently authorized activities as well as the proposed amounts for the new activity during the Strategy Period. A Mission Review of this RP document was held on March 5, 1998, at which time the document was approved verbally.
2. Decentralization and Rural Poverty Reduction Activity (DRPR), Number 519-0442, at a funding level not to exceed \$4,000,000, for an expected duration of five years, from FY 1998 through FY 2002. A Mission Review of this NAD was held on April 2, 1998.

**II. BACKGROUND**

El Salvador has made important advances in terms of macroeconomic stability in recent years. By 1997, the rate of inflation had been reduced to around two percent, the fiscal deficit was around two percent, the real rate of growth was around four percent, and remittances were continuing to rise. The growth process has contributed to declining rates of poverty in the principal urban areas.

Notwithstanding these achievements, poverty in rural areas has remained fairly constant and this persistence presents an urgent challenge. According to the annual Household Survey conducted by the Ministry of Economy, poverty in rural areas has remained a fairly constant 65 percent of rural households throughout the 1990's, with an annual per capita income of less than \$360. During the same timeframe poverty in urban areas decreased by about 11 percent.

In other words, El Salvador has successfully implemented economic reforms resulting in low inflation and a sustainable growth process. Nonetheless, growth is not translating into a proportional reduction of rural poverty.

There are several factors that explain the persistence of rural poverty, despite recent relatively strong economic growth. First, a centralized economic system serves to concentrate resources and economic activity in urban areas, especially in the San Salvador metropolitan area. Second, public investments in human capital and basic infrastructure (i.e., roads, potable water, electricity and telecommunication services) have been concentrated in urban areas. Lastly, there is persistently low growth and productivity in the agricultural sector, where rural households generate most of their income.

These are the primary causes of rural poverty. To address them in a systematic manner the GOES needs both i) to become more efficient in its provision of basic services, and ii) raise the level of concern for rural poverty reduction to become a national priority.

In this context, the USAID/El Salvador Mission Strategy for the period 1997-2002 states that "one of the USAID's main strategic objectives is to expand access and economic opportunities for rural families in poverty." To that end, the USAID Economic Growth Office has created five Results Packages. In the area of economic policy, the Results Package No. 5 was created, which has as its main goal to promote an economic policy environment to support greater equity.

Activities currently implemented by the policy RP address some of the barriers to economic growth in rural areas. For example, privatization of basic infrastructure has been supported by the USAID's 0349 activity. The Mission has also a contract with CID-Gallup that will provide survey information on the quality of services of the Ministry of Public Works. To promote competition in rural input and output markets the Policy RP has initiated some activities. The Mission's buy-ins to the BASIS CRSP research program in El Salvador will provide detailed information on poor rural households, and the input and output markets in which they participate. Efforts to improve agricultural policy and disseminate markets and price information to producers are now supported by USAID's CRECER policy activity.

The DRPR will complement the other activities of the Policy RP in assisting in the development, public debate and implementation of policy reforms that facilitate infrastructure investment and better provision of publicly funded services in rural areas. The activity will also promote competition in domestic input and output markets and the regulation of the privatized public utilities.

### III. DISCUSSION

#### A. Challenge, Expected Results and Targets

The Economic Policy RP plays a key role in encouraging and supporting national efforts to implement fundamental reforms -- changes to promote economic growth that is deeply rooted, broadly-based and more sustainable. The current challenge of this RP is to promote policy mechanisms to extend the benefits of economic growth to rural households. This challenge is addressed through two approaches, which are the RP5 sub-intermediate results:

##### 1. Modernization of the State leads to economic growth and better rural services

###### a. Expected Result:

Modernization of the State is a broad heading under which falls a lengthy menu of reforms. The core concern is realignment of the functions of government in El Salvador, to promote efficient and cost-effective provision of essential services, and to remove the state as a player from areas better left to the private sector.

###### b. Key Reforms Targeted:

The GOES roadmap for Modernization of the State sets out the following as among key reforms needed in government: expanding the proportion of government expenditure devoted to provision of social services such as basic education, reducing state intervention in the functioning of private markets, increasing the transparency of government operations, closing the loopholes for corruption, enhancing public accountability, promoting efficiency and expanding equality of economic opportunity.

Other reforms covered under the Modernization of the State rubric promote the efficiency of the economy. An important example is trade liberalization. Lowering barriers to trade is a key element for achieving greater economic efficiency, boosting export markets, and advancing the goal of reducing poverty in rural areas. A low more uniform level of protection, together with participation in multilateral trading arrangements, will create demand for El Salvador's export products and jobs for its labor force, especially in the rural areas.

USAID/El Salvador provided substantial support to the reforms mentioned above. With the new activity, the DRPR will continue working within the GOES modernization of the State strategy, but this time, supporting primarily elements that lead to improved infrastructure and expanded basic services in rural areas as well as other policies that promote broadly-based economic growth.

Among the reforms targeted is the removal of barriers to extension of public basic infrastructure in rural areas. This will be addressed by promoting decentralization of public finances, so that local governments in rural areas can address citizens' needs in a more effective and accountable way. The activity will also help the central and local governments to develop private market mechanisms to finance infrastructure construction and maintenance, such as concession contracts. The new activity will also support policy reforms that promote competition within domestic input and output markets and develop consumer protection mechanisms. An important activity under the competition policy rubric is technical assistance to the government (both national and local levels) to adopt appropriate regulatory frameworks for the privatized basic infrastructure.

## **2. GOES Adopts and Implements a Rural Poverty Strategy.**

### **a. Expected Results:**

Rural households lack access to employment and income opportunities, education, basic services (such as health, clean water and sanitation), and productive infrastructure. While there are piecemeal initiatives by both public and private sectors to address different aspects of rural poverty, the effort would be far more powerful and effective, in the view of USAID and its partners, if the GOES were to adopt an official posture that rural poverty reduction is a national priority.

### **b. Key Reforms Targeted:**

In the context of this intermediate results, the Policy RP addresses three specific targets:

1. Rural Poverty reduction becomes a clear national priority
2. A Rural Poverty Strategy receives substantial coordinated support from central and local governments, as well as from donors and NGOs.
3. Policy reform development and public debate on the issues mentioned above, such as rural access to basic services and infrastructure, competition and infrastructure finance, will be key elements for the emergence of a national strategy for rural poverty reduction.

## **B. Policy Result Package Instruments**

To address its challenges and achieve its expected results and targets, the policy RP currently includes four instruments (0349, Economic Reform and Civil Society, BASIS and CRECER). By mid 1998 the new activity will start, which will continue further

steps in the area of both sub-intermediate results:

**Technical Support, Policy Analysis and Training (519-0349).**

PACD - September 30, 1998  
 LOP Resources - \$35.50 million  
 Counterpart - \$11.80 million

**Economic Reform and Civil Society**

With funding from the Emerging Market's Support for Economic Growth and Institutional Reform (SEGIR) Activity No. 936-4212.

Completion Date- October 5, 1999  
 LOP Resources - \$250,000.00  
 Counterpart - 0

**Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS)**

PACD - 2001  
 LOP Mission Contribution - \$200,000 (from PD&S and 0349)  
 Counterpart - TBD

**Rural Equitable Economic Growth, Policy Component (CRECER).**

PACD - May 30, 2000  
 LOP Resources - \$5.43 million  
 Counterpart - \$1.00 million.

**Decentralization and Rural Poverty Reduction**

PACD - 2002 (est.)  
 LOP Resources - \$4.00 million  
 Counterpart - \$1.33 million

The first activity concentrates on supporting the modernization of the state. In this context, efforts have been aimed at increasing the efficiency and cost effectiveness of public institutions; improving public sector accountability; assisting the GOES on policy formulation; and promoting greater access to basic services in order to maximize social welfare.

The second activity, Economic Reform and Civil Society, has provided technical assistance to the public and private sectors for the design, discussion and analysis of economic policy reform proposals. Under this activity, the Mission has assisted the Municipality of San Salvador with a tax reform proposal. A seminar and technical assistance on the New Zealand experience relating to central bank independence was provided to generate public opinion on the possibility of applying some aspects of the New Zealand model to the case of EL Salvador. The activity has also responded to other ad hoc requests for technical assistance.

A third Policy RP activity is a buy-in to the Global Bureau BASIS CRSP (Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program). The Mission initiated its involvement with the BASIS CRSP in FY 1997, with a small

grant to FUSADES, the chief local collaborating institution, to conduct the second rural poverty survey.

The awarding of the BASIS CRSP was fortuitous for SO1 because the logic of the research program is a virtual match with the SO1 strategy in its focus on labor, credit, and other input markets in rural areas.

The fourth instrument/activity is the policy component of CRECER, centering its assistance on backing the Ministry of Agriculture's institutional and policy efforts to expand access and economic opportunity to rural poor families. More specifically, the policy component of CRECER aims to strengthen the branches of the Ministry of Agriculture responsible for economic data and policy analysis.

The new activity under the Policy RP, entitled "Decentralization and Rural Poverty Reduction," will promote an economic policy environment supporting greater equity. The main components for this activity directly address both sub-intermediate results: modernization of the state, and GOES adoption of a rural poverty strategy. The activity will complement efforts of the other SO1 RP activities, as well as the GOES and other donor initiatives.

The DRPR activity will be implemented using four different implementation arrangements. They are:

- 1) Additional funding for the RP's contract with the 8a firm Devtech Systems;
- 2) Buy-ins to the SO1 Human Capacity Development Activity;
- 3) Small Assistance Instruments to local Salvadoran organizations, and
- 4) Specialized technical assistance through Global Bureau buy-ins and IQC contracts.

The details of these mechanisms are outlined in the NAD document, pages 17 to 19.

The total amount to be obligated under this activity is US\$4,000,000. The required counterpart contribution, for both GOES and NGOs, is approximately the equivalent of US\$1,334,000, which represents 25% of total resources.

The funding for the new activity will be amended into the SO1 Strategic Objective Grant Agreement. No additional conditions precedent or covenants will be required.

### C. Results measurement and Reporting

As noted above, the main goal of the Policy Intermediate Result is to help create an economic policy environment supporting greater equity through the achievement of two lower level intermediate results: a) modernization of state leads to economic growth and better rural services; and b) support the GOES to adopt and implement a rural poverty strategy. The policy RP has three indicators to measure progress toward these intermediate results. They are the following:

For the upper level Intermediate Result, "Economic Policy environment supporting greater equity," progress is measured using the "growth elasticity of poverty." This indicator is computed using the ratio of the percentage change in poverty and the percentage change in per capita income. The elasticity will be estimated for both rural and urban areas, and will demonstrate progress over time in extending the benefits of economic growth to the rural areas. (i.e., progress toward equalization of the growth elasticity coefficient between the rural and urban areas).

For the lower level intermediate results, there are two indicators, one for each lower level intermediate result.

1. Progress toward the first lower level intermediate result, "Modernization of the state leads to economic growth and better rural services," is measured by the Index of Modernization of State, which includes eight weighted indicators, namely public utility privatization, private provision of infrastructure, pension reform, equitable allocation of public sector budget, fiscal and monetary institutions for the long run economic policy, and neutral incentives to traded sectors.
2. As for the second lower level intermediate result, "GOES adopts and implements a rural poverty strategy," progress is measured by the share of the GOES investment budget directed to the poorest departments. This indicator also measures equity in the budget allocation process.

To incorporate all the areas of work contemplated under the new activity, an additional indicator will be added for the RP when the DRPR begins implementation. This indicator will measure progress in the decentralization of public finances.

These indicators will be reported to the Mission in SARs and R4 documents.

**IV. MISSION REVIEW**

- A. On March 5, 1998, the Mission met to review the Economic Policy Results Package. Two major issues were discussed and their resolution is as follows:

**Issue No. 1:**

The current Project Assistance Completion Date (PACD) for Activity No. 519-0349, is September 30, 1998. However, the RP has received different proposals requesting financial support oriented to the efforts being made by the GOES related to pension reform, fiscal institutions, Multipurpose Household Survey, and agricultural projects. Given that the current pipeline for this activity is \$2.5 million, it will not be possible to spend all funds by the PACD since full implementation of these activities will require additional time. Under these circumstances, would the Mission approve the extension of the PACD to March 31, 1999, so as not to risk losing the funds?

**Response:** The decision regarding extending the PACD will be taken after reviewing and discussing the final program of activities based on the current pipeline.

**Issue No. 2:**

Economic policy is a very dynamic area and activities are continuously changing based on economic, political and social developments. Because of that fact, the Mission, and particularly the Policy RP, must have indicators which can be flexible and easily adjusted to a changing policy climate. Should the RP have the authority to adjust policy indicators from time to time to appropriately measure the impact of Mission's activities?

**Response:** In principle, the proposal for flexibility was not accepted by Mission Management, unless in the future there exists a justification for updating the indicators because of, for example, reorientation of policy activities due to changes of the economic policy of the country.

**Other Resolution:** After discussion during the RP review concerning the Workforce Table, it was reviewed and modified (See Annex I).

- B. On April 2, 1998, the Mission met to review the Decentralization and Rural Poverty Reduction Activity. During the meeting two major issues were discussed and their resolution is as follows:

**Issue No. 1:**

Although the activity contemplated working with several counterpart institutions within the public sector, the document does not specify the role the GOES will play in the policy reform process. How will the activity ensure that the GOES will support and approve the policy reforms contemplated in the NAD?

**Response:**

The new activity starts in a presidential pre-election year. Until mid 1999, policy directions will not be clear and policy implementation is very difficult.

Under these circumstances, and given the limited amount of funds for this activity, the Policy RP will seek to enrich the national dialogue on policy reforms by providing technical expertise, training and financial support to local government and local NGOs working on policy reform issues. When the new executive branch leadership takes office, USAID will continue to seek opportunities to assist the central government in the design and implementation of policy reforms.

**Issue No. 2:**

What mechanisms are proposed to ensure coordination between SO1 and SO2 in fiscal decentralization activities as well as between USAID and other donors?

**Response:** At present, there is a SO2 member participating in the Economic Policy Result Package Team. To complete the coordination, it was decided in the meeting of the NAD review, that a SO1 member will participate on the Municipal Development Result Package Team, SO2.

**Clarification:**

The NAD describes adequately and appropriately the emphasis that will be placed on policy interventions that have an impact on our rural customers. The NAD also identifies Promoting Competition as a key factor. Our counterparts in the justice sector have identified the need to reform and modernize the civil and commercial legal system which impacts directly on promoting competition. We have heard that it takes up to seven years to resolve a claim in the civil courts. To the extent that small producers and entrepreneurs in rural areas do not have redress to the legal system to resolve commercially based legal complaints or violations of contractual obligations, should this NAD include a possible component in commercial legal reform?

**Response:**

The RP will inquire whether or not other donors are working on these issues and will define areas where USAID could complement these efforts.

## C. Special Actions Required

Initial Environmental Examination was approved for this RP. (See Annex D, RP document).

## D. Congressional Notifications

Technical Assistance, Policy Analysis and Training Activity No. 519-0349 most recent CN expired 08/30/91.

CRECER Activity No. 519-0397 most recent CN expired 9/28/95.

Policy Development for Rural Poverty Alleviation No. 519-0442 Congressional Notification (CN) was sent to Washington for approval.

No funds will be obligated for this Activity until the CN has been submitted to the appropriate Congressional Committees and USAID/El Salvador has been notified that the required time period has expired and obligation may occur.

**V. AUTHORITY**

Pursuant to ADS Section 103.5.14b(1), you have been delegated the authority in ADS Section 103.5.8a(1) to develop operating unit strategic plans and admendments thereto and to realign, as appropriate, on-going activities under strategic, special or support objectives; provided that the AA/LAC must approve any substantive amendments to the Mission's approved strategic plan and any substantive amendments to the terms and conditions of the Mission's management contract with the LAC Bureau. The Economic Policy Results Package No. 5 for Strategic Objective No. 1 and the New Activity Description for the "Decentralization and Rural Poverty Reduction," Activity No. 519-0442, requested to be approved in this Action Memorandum are consistent with both the approved Mission strategic plan and the current management contract between the Mission and the LAC Bureau, as supplemented by the recent R4 submitted to the LAC Bureau, and will not require any amendments to either of those documents. Therefore, you have the authority to authorize Results Package No. 5 and the New Activity, No. 519-0442.

**VI. RECOMMENDATION**

That you approve the Economic Policy Results Package No. 5: "Economic Policy Environment Supporting Greater Equity" at a funding level not to exceed \$45,183,000 and for an expected duration of six years; and the Decentralization and Rural Poverty Reduction Activity No. 519-0442 at a funding level not to exceed \$4,000,000 and for an expected duration of five years (from FY 1998 through FY 2002) in support of this Result Package, under the SO1, Expanded Access and Economic Opportunity for Rural Families in Poverty, by signing below.

Approved

J. Ellis

Disapproved

Date

June, 1998

Attachment: Economic Policy Results Package and the Activity Document.

USAID Management Costs

As indicated in the table below, the total USAID management costs dedicated to this RP are estimated to be US\$ 157,750 per year, out of which US\$ 13,450 are financed from current activities under the RP, US\$ 48,650 are financed from Operating Expenses and the remaining US\$ 95,650 are financed from Trust Funds.

Org. Unit	Employee Type	Person/ Years	Source of Funding			COST PER YEAR
			RP	OE	TF	
SO1	FSN-PSC	1.00			X	\$22,000.00
SO1	FSN-PSC	0.60			X	26,600.00
SO1	FSN-PSC	0.50	X			13,450.00
SO1	FSN-DH	0.50			X	25,600.00
SO1	FSN-DH	0.15			X	6,650.00
SO1	US-DH	0.25		X		23,400.00
SO2	US-DH	0.25		X		16,250.00
SDO	FSN-PSC	0.15			X	3,200.00
SDO	US-DH	0.15		X		9,000.00
OCG	FSN-PSC	0.15			X	2,700.00
CONT	FSN-PSC	0.15			X	3,100.00
CONT	FSN-DH	0.15			X	5,800.00
<b>TOTAL</b>		<b>4.00</b>	<b>0.50</b>	<b>0.65</b>	<b>2.85</b>	<b>\$157,750.00</b>

Note: This workforce table represents USAID/El Salvador's estimate of its resources used in project management, and does not reflect any AID/W instructions in this regard.

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