

El Salvador
Public Finance and Social Sector Development Policy Loan (Loan No. 7635-SV)
Release of the Second Tranche – Partial Waiver of Conditions 1 and 7
Tranche Release Document

1. This document summarizes progress made under the Public Finance and Social Sector Development Policy Loan (DLP) for El Salvador. Conditions for tranche release are specified in Section II.C of Schedule 1 of the Loan Agreement. The following report presents the actions taken by the Government to meet the specific conditions for release of the second tranche. On the basis of full completion of 5 of the 7 conditions and partial completion with evidence of significant progress of the partially waived conditions, this memorandum recommends that the second tranche be released.

I. Background

2. The Board approved the Public Finance and Social Sector Development Policy Loan (DPL) (Loan No. 7635-SV) of USD 450 million on January 22, 2009. Following the Board decision, the loan agreement was signed on January 29, 2009 and became effective on February 25, 2009. The loan was to be disbursed in two tranches of USD 200,000,000 and USD 248,875,000 respectively. An amount of USD 1,125,000 was allocated to pay the front-end fee.

3. The DPL was designed to assist the government in addressing fiscal and public finance management related issues and support continued institutional and social sector reforms. The main objectives of this operation were to: (i) help El Salvador strengthen medium-term fiscal sustainability; (ii) support good governance and transparency in the use of public resources; and (iii) maintain steady improvements in social protection and education. In order to achieve these objectives, the Public Finance and Social Sector DPL supports actions aimed at: (i) expanding fiscal space for priority spending and improve targeting of public spending; (ii) improving public expenditure management and fiscal transparency; and (iii) expanding social protection programs, enhancing the quality of primary education and expanding access to secondary education.

4. The operation's strategy of addressing the fiscal situation and maintaining socio-economic progress was defined in conjunction with different actors of El Salvadorian society. Given the potential medium-term implications of the operation, and in particular the fact that its implementation would straddle two administrations and involve legislative action in some instances, the strategy and program were carefully negotiated and agreed with a range of political actors (including the main opposition party at the time – the Frente Farabundo Marti para la Liberación Nacional –FMLN–) as well as key civil society institutions and private sector organizations. The program, supported by the Public Finance and Social Sector DPL, involved both immediate actions to protect households from the impact of external shocks as well as medium-term initiatives aimed at creating more fiscal space, increasing efficiency and transparency in the use of public resources and maintaining the pace of social sector reform efforts.

5. The first tranche of the DPL was disbursed following the completion of seven actions: (i) the borrower has implemented tax administration measures to fight tax evasion and raise revenues through: (a) the creation of a functional criminal investigation unit within the tax administration office, (b) the establishment of a cooperation agreement between tax and customs administration offices to cross-check tax collection information, and (c) the creation of a functional internal affairs unit, organized within the tax administration office; (ii) the borrower has approved a plan to gradually eliminate the electricity subsidy for firms and initiated its implementation by cutting the said subsidy by 40 percent; (iii) the borrower has strengthened public financial management by expanding the integrated financial management system to at least 24 entities of the central government, 59 decentralized public institutions and 2 public companies; (iv) the borrower has increased transparency and efficiency of its public procurement system by implementing the public procurement dissemination module MODDIV of COMPRASAL in at least 172 government agencies and municipalities; (v) the social protection program *Red Solidaria* became fully operative in 77 of the poorest municipalities it targets; (vi) the borrower through the Ministry of Education, has: (a) developed and implemented an education quality monitoring system using standardized learning assessment for primary education students and (b) developed a strategy to address deficiencies in non-performing schools, including a monitoring system for teachers, a peer collaboration program, enhanced distribution of education material, and a training program for teachers; and finally (vii) the borrower has: (a) eliminated tuition and graduation fees in regular public schools and (b) created 20,000 education grants to pay for alternative secondary education under the EDUCAME program).

6. The implementation of the reforms supported by the first tranche led to most of expected outcomes. Since the release of the first tranche, the number of taxpayers increased by 9.7 percent for ad-valorem taxes and by 4 percent for income taxes. While a larger than expected slowdown in economic activity has prevented the government from reaching the project target for tax collection in 2009 (set at 14.1 percent of the GDP), economic recovery and the recent tax reforms are expected to put revenues back on track in 2010. The amount of untargeted subsidies decreased by more than 40 percent between July 2008 and July 2010, surpassing expectations. The social protection program, *Comunidades Solidarias* (previously *Red Solidarias*), reached 100,400 households in May 2010. In 2009, the program distributed a total of USD 19.2 million to about 100,000 households, outperforming with respect to the project targets of USD 12.6 million and 85,000 households respectively. Finally, by the beginning of July 2010, 100 percent of central government expenditures were being recorded, accounted and controlled according to international public financial management standards.

7. The next sections of this document present the recent economic developments and describe the results achieved in carrying out the reform program related to the release of the second tranche of the Public Finance and Social Sector DPL. More specifically, the document argues that the macroeconomic policy undertaken by El Salvador in this period was consistent with the objectives of the operation and that the government made significant progress in the areas supported by the loan.

II. Recent Economic Developments

8. The Salvadoran economy has faced important changes since the preparation of the Public Finance and Social Sector DPL. Yet, the operation remains extremely relevant to the country's challenges. On the internal front, after 20 years in the opposition, in March 2009 the FMLN came to power with the election of Mauricio Funes for president. The new government platform consolidated the advance of the social policy agenda as a priority, although it recognized the importance of sustaining macroeconomic stability and building consensus during this process. On the external front, changes relate to the global financial crisis. On the one hand, the crisis contributed to a drop in international commodity prices, easing the inflationary pressures faced by the country in 2008. On the other hand, the extension of the crisis and its contagion to the Salvadoran economy were more serious than anticipated. While the policies supported by the DPL have helped to reduce the fiscal concerns generated by the crisis, the release of the second tranche will assist the government in sustaining social spending until the economy fully recovers.

9. The global financial crisis, and in particular the US recession, severely affected the Salvadoran economy in 2009. As a result of the sharp fall in proceeds from remittances, lower private capital inflows, and reduced foreign demand, real GDP contracted by 3.5 percent in 2009. The slowdown hit all sectors, with manufacturing, construction, and retail being the most impacted. In addition, output from agriculture contracted in 2009 due to a tropical storm late in that year. The economic recovery is expected to be slow. Current estimates foresee a recovery in GDP growth rates to about 1 percent in 2010, 2.5 percent in 2011, around 3 percent in 2012, and 4 percent in 2013 (table 1).

Table 1. Macroeconomic Outlook
(percentage of GDP, unless otherwise indicated)

	2009	2010	2011	2012	2013
Income and Prices					
GDP growth (% change)	-3.5	1.0	2.5	3.0	4.0
Inflation (cpi end of period % change)	0.0	1.5	2.8	2.8	2.8
Consolidated Public Sector					
Primary balance	-3.0	-2.4	-0.4	0.4	1.0
Overall balance	-5.6	-4.8	-3.5	-2.5	-2.0
Public debt					
Total debt	50.4	51.7	52.8	52.5	51.3
O/w External	26.3	27.0	27.7	27.3	26.4
External public debt servicing (% of exports)	11.7	11.0	22.2	10.6	9.7
Balance of Payments					
Current account balance	-1.8	-2.8	-3.3	-3.4	-3.4
Trade balance	-13.5	-15.1	-15.5	-15.4	-15.4
Exports of goods (f.o.b.)	18.3	19.6	20.5	20.9	21.1
Imports of goods (f.o.b.)	32.9	34.7	36.1	36.3	36.5
Foreign direct investment	2.7	1.7	1.8	1.9	2.0
Remittances	16.9	17.5	17.8	17.8	17.7
Memorandum Item					
Nominal GDP (billions of US dollars)	21.1	21.8	23.0	24.3	26.0

Source: Ministry of Finance, Central Bank and IMF and World Bank staff estimates.

10. The dollarization regime, an important stabilization pillar for El Salvador, withstood the global financial crisis without major strains. El Salvador's financial system

showed no sign of distress during the period, maintaining adequate levels of liquidity and relatively low risk, though there was some tightening of credit. In the external sector, pressures created by the drop in exports (17 percent) and remittances (8.5 percent) were more than compensated by a sharp decline in imports (26 percent) in 2009. The improvement in the trade balance contributed to a reduction of the external current account deficit to 1.8 percent of GDP in 2009 from 7.6 percent in 2008. Net capital flows also fell, but remained positive overall, as higher government borrowing more than offset private capital outflows and low foreign direct investments (FDI) flows. As a result, net international reserves rose by about USD 440 million. The current account deficit is expected to deteriorate slightly in 2010 caused by a pick-up in import demand and a rise in commodity prices but remain at manageable levels.

11. The deterioration of the fiscal situation during the crisis has become the main source of macroeconomic concern. Despite the government efforts to restrain public expenditure, the Consolidated Public Sector deficit reached 5.6 percent of GDP in 2009 driven by the sharp decline in government revenues. The larger-than-expected fall in economic activity resulted in a significant drop in tax revenues from 13 percent of GDP in 2008 to 12 percent in 2009. In 2010, the fiscal deficit is projected to improve moderately, but still remain at 4.8 percent of GDP as the sluggish economic recovery will challenge any substantial increase in tax revenues. However, the tax reforms initiated in early 2010 and spending control measures taken by the new administration will help narrow the fiscal deficit in the short term.

12. In order to deal with the effects of the crisis and assure medium-term fiscal sustainability, the government has crafted a fiscal strategy supported by an IMF Stand-by Arrangement (discussed by the IMF Board in March 2010). The program envisions a gradual increase in the primary surplus promoted mainly through revenue increases. Under the program, the overall deficit should decrease to 2 percent of GDP in 2013, while total public sector debt would initially increase from 50.4 in 2009 to 52.8 in 2011 to start declining afterwards. While there are risks associated with the implementation of the IMF program, such as a lower than expected growth or delays in the reforms implementation, stress-tests show that the medium term debt path is sustainable even under a wide range of alternative scenarios.

13. On the basis of the previous discussion, the assessment made at the time this operation was approved by the Board regarding El Salvador having an appropriate macroeconomic framework for development policy lending continues to be valid at this time.

III. Progress against Tranche Release Criteria

14. The Government has made significant progress in implementing the program of Public Finance and Social Sector reforms supported by the DPL. It has fully implemented five of the seven conditions to be carried out prior to the release of the second tranche. In addition, the government has successfully concluded two of the three elements composing Condition 1 and one of the two elements composing Condition 7. In both cases, the elements not completed reflect the implementation of new, improved strategies and should not be interpreted as an indication of lack of government's commitment to the

project's objectives. The implementation process for each condition is summarized below.

15. Condition 1: The Borrower has made progress towards raising tax revenues as evidenced by: (a) the implementation of a new tax on vehicles; (b) the introduction of an ad-valorem tax on alcoholic beverages; and (c) the installation and operation of x-ray machines and weight controllers in the Borrower's customs posts of Acajutla, San Bartolo and Comalapa Airport.

16. **This condition was partially met.** The first two items, the new tax on vehicles and the ad-valorem tax on alcoholic beverage, were implemented as part of the tax reform, through the legislative decrees No. 234 and No. 239, respectively, that were approved by congress on December 17, 2009 and became effective on January 4, 2010. More specifically, the reform created a tax on new vehicles to compensate for lowering import duties on vehicle imports under the CAFTA-DR agreement. The tax estimated yield is 0.1 percent of GDP on an annual basis. In addition, excise taxes on alcoholic and carbonated beverages and tobacco were increased and made applicable to non-carbonated products. Unitary taxes on alcoholic products were also increased and a new 5 percent ad-valorem tax on these products was introduced. The combined estimated yield of these measures is 0.3 percent of GDP on an annual basis. Aside from these new taxes, the government made improvements in tax administration and they plan to step up these efforts in 2010 by: (i) unifying the tax collection process under the Ministry of Finance; (ii) moving away from tax audits based on the auditors' current portfolio to risk-based auditing; (iii) using a newly created taskforce to identify non-filers and stop-filers; and (iv) updating and modernizing the large taxpayers unit.

17. The third item, the installation of x-ray machines and weight controllers in the customs posts of Acajutla, San Bartolo, and Comapala Airport, has not been completed and due to a change in the government's strategy will not be met as specified in the legal agreement. The government is committed to develop an efficient customs control system and has taken significant steps in this direction. After taking office in June 2009, the new government commissioned a detailed assessment of strategies for customs control. The study revisited the customs strategy and identified a number of areas for improvement. The original strategy supported the implementation of the equipment in the largest port, the largest airport, and the central customs office. The central office would support control processes for merchandise imported through the different border points that were not capable of carrying out importing procedures. The study concluded that trucks and containers would face high risks of diversion on their way to the central office, significantly reducing monitoring effectiveness. For this reason, the government decided to proceed with a different and more comprehensive strategy for customs control, covering the seven largest entry and exit points responsible for 75 percent of the trade volume. This strategy does not foresee the need for installing new equipment in San Bartolo in the medium term, something that in turn would prevent the fulfillment of the first condition for the release of the second tranche.

18. The Bank has discussed with the authorities the new strategy and agreed that it is an improvement over the previous one. Given the higher cost of the new strategy, the government is considering alternative options such as leasing the equipment rather than acquiring it. While it will take longer to be implemented, the simultaneous installation of

equipment in all seven posts through concession is in the Bank's view both more efficient and more effective than the previously proposed partial implementation with the purchase of equipments by the government. The government is currently at the stage of selecting service providers. The new strategy, supported by the Fiscal Management and Public Sector Performance Technical Assistance from the World Bank, is currently in line with the proposed implementation schedule and it is expected to be fully implemented by September, 2011.

19. Taking into account the factors behind the change in government strategy, the continued commitment of the government to improve customs control, and progress made so far, it is recommended that the component of Condition 1 referring to the installation and operation of x-ray machines and weight controllers in the three customs posts mentioned above is waived.

20. Condition 2: The Borrower has completely eliminated the Electricity Subsidy for Firms.

21. **This condition was fully met.** There have been two different types of subsidies for electricity consumption in El Salvador. First, a generalized subsidy benefiting all households and businesses with access to electricity, and second a targeted subsidy to households with consumption below 99 kWh a month. The general subsidy amounted to 0.7 percent of GDP or 35 percent of the cost of all subsidies in 2008. In March of 2009, the generalized subsidy was completely eliminated by the government, leaving only the targeted subsidy for households. The end of the general subsidy represented the end of electricity subsidies received by firms as described in the letter from legal representatives from SIGET - *Superintendencia General de Electricidad y Telecomunicaciones* - and FINET - *Fondo de Inversión Nacional en Electricidad y Telefonía*. The end of the benefit is also supported by the financial statements from FINET and published tariff schedules. In April 2010, however, given the increase in international petroleum prices, it became clear that an 18 percent increase in prices would be necessary in order to reflect the prices being offered by generators in El Salvador. As a result, a temporary subsidy was again reinstated, this time fixing prices only for residential consumers (executive decree n. 44 published in the Official Gazette on March 26, 2010). Prices were fixed to the average level that was in place over the previous 6-month period. The government confirmed that, in line with the commitment to this condition, it has no intention of restoring the benefit for firms.

22. Condition 3: The Borrower's budgetary management has been improved through: (a) the introduction of a medium-term budget framework; and (b) the piloting of a results-based budgeting methodology, including the use of performance indicators linked to budget allocations, in at least two central government agencies.

23. **This condition was fully met.** As part of a program to strengthen public resource management and improve the budget process, the government has defined a medium-term budget framework that will be incorporated to the budget law of 2011. The framework, created by executive decree No. 891 bis, states medium-term fiscal policy objectives and presents four year forecasts for the main macroeconomic and fiscal indicators. The medium-term framework seeks to support the 2009-2014 government program while assuring fiscal sustainability. In addition, the government has defined a

result-based budgeting methodology that is currently being piloted in the Ministry of Agriculture and the Ministry of Health. The methodology follows international best practices, linking policy objectives to the budget allocations and to different types of performance indicators. Performance indicators are used both as a monitoring device and as an input to the following year's budget.

24. Condition 4: The Borrower has: (a) issued regulations to enable and promote public access to fiscal information; and (b) redesigned and launched an effective Fiscal Transparency Portal, including user-friendly applications to access and consult information.

25. This condition was fully met. Transparency and freedom of information are deemed critical to mitigate negative perceptions and mistrust among other stakeholders. The El Salvador government has made considerable progress in advancing the transparency agenda. While the actions linked to the first tranche of this loan focused on the transparency and efficiency of the public procurement system, the condition for the second tranche focus the accessibility of information for the annual budget law, the annual state financial management report as well as the dissemination of interim reporting on public finance and investment programs. Executive decree No. 850 from July 21, 2010 defines the norms for the public access to public financial information. Supported by the agreement, the Ministry of Finance has successfully launched a new, more effective, Fiscal Transparency Portal that provides easy access to a broader set of fiscal data, incorporating elements from international best practices as intended by the condition.

26. Condition 5: The Borrower has further expanded *Red Solidaria* to fully cover its poorest 100 municipalities.

27. This condition was fully met. The program *Red Solidaria*, now known as *Comunidades Solidarias Rurales*, is a conditional cash transfers program targeting the poorest municipalities of the countries. The program was designed with the support of the World Bank sharing international best practice. There is wide consensus that the program fulfills its main objectives of supporting the consumption of poor rural households and increasing the access of their children to basic health, nutrition and education services. Moreover, the expansion of the program in rural areas is usually accompanied by significant increases in the availability of public health and education services, thereby facilitating access to and, utilization of, these services. By the end of 2008 the government successfully expanded the program to a group 77 targeted municipalities among the poorest in the country as a prior action for the release of the first tranche of the loan. In 2010, the government expanded the full coverage to other 23 municipalities, reaching the 100 poorest municipalities in the country (the 32 municipalities identified as in severe extreme poverty and the 68 identified as in high extreme poverty). The liquidation report of bi-monthly transfers provides evidence of the beneficiaries enrolled to the program in these municipalities. Given the increasing concern about addressing urban poverty and social exclusion, the Government has started implementing a similar plan to support poor urban households, the *Comunidades Solidarias Urbanas*.

28. Condition 6: The Borrower, through MINED, has: (a) implemented a strategy to address nonperforming schools deficiencies in all schools with average

grades of 5 points or less in the PAESITA Test; and (b) undertaken a special mid-term test for targeted non-performing schools to assess progress and improvements.

29. **This condition was fully met.** El Salvador has made good progress in expanding access to primary education with 94 percent of children now enrolled in school. Quality, however, has lagged behind, particularly in schools in poor areas, where students have more limited educational support at home. In fact, a national exam (Prueba de Logros or PAESITA test) applied in 2008 identified a group of 411 low-performing schools (with average grades below 5 points). In the last year, the government has successfully implemented a strategy to address deficiencies of non-performing schools. The strategy included training programs for teachers (*'cursos de adecuacion de contenido'*), systems for exchanging of best practices and peer collaboration among public schools (*'reflexiones criticas'* and *'redes de docents'*) and better distribution of educational material. Performance in these schools was monitored through standardized quarterly exams to first year primary school students during the school year of 2009. The exams, designed to compare actual learning with the expected knowledge at a given stage of the year, were applied as part of the classroom activity in all low-performing schools. Results were then processed by the Ministry of Education and summarized in a progress report. In order to further assess progress, the Ministry of Education applied a new PAESITA Test in September 2010. The test specifically targeted the 411 underperforming schools.

30. **Condition 7: After December 31, 2008, the Borrower has: (a) increased the number of education grants (*cupos*) under the EDÚCAME program by 10,000; and (b) increased by 200 the number of operating classrooms of up to 40 students (*secciones*) for secondary education in public schools.**

31. **This condition was partially met.** EDÚCAME is a public program created in 2006 to promote higher enrollment in secondary education, especially among young people who have abandoned the formal education system and are currently participating in the labor force. The program offers grants and flexible modalities for completing the secondary curriculum – including, among others, web-based distance learning, accelerated secondary programs and “flex-time” courses. The total number of students under EDÚCAME significantly increased since its creation reaching about 55,000 in 2008. However, in 2009 the Ministry of Education concluded the first monitoring and evaluation cycle covering all the current modalities of the program (distance, accelerated, flex time, night school, virtual), which detected a number of structural problems with the quality of some of the offered modalities. As a result, the government decided to focus on consolidating the program before continue its expansion. Several actions have been taken to increase the efficiency and academic quality of the program. These include: i) the creation of an electronic registry system for students and teachers under the newly incorporated modalities; ii) the re-training of 261 exiting teachers and the training of 1,987 new tutors; iii) the distribution of the new education materials; iv) the reduction of the average classroom size; and v) the application of standardized end of the year exams to all students in the program. Under the new strategy, EDÚCAME expansion was limited to only 1,400 grants in 2009, remaining below the target of 10,000 grants as per the DPL.

32. The modest increase of EDÚCAME grants was partially compensated by a larger expansion than anticipated in the regular secondary system. In fact, the resulting overall

increase in secondary enrollments remains close to the targeted outcome. The actions supported by this DPL expected to increase secondary education enrollment by a total 18,000 students between the release of the first and second tranches - 10,000 under EDÚCAME, and 8,000 under the regular public secondary system. In practice, enrollment has expanded by approximately 15,400 students: the 1,400 EDÚCAME grants created in 2009 and approximately 14,000 new students enrolled in the regular system in the same period.

33. Finally, the government has successfully met the second part of this condition. Records from the Ministry of Education indicate that 381 operating classrooms (*secciones*) have been added to the regular public secondary system since the end of 2008, with approximately 360 operating classrooms (*secciones*) having 40 or less students.

34. Taking into account the factors behind the change in government strategy, the continued commitment of the government to increase both enrollment and quality of secondary education, and progress made so far it is recommended that component of Condition 7 referring to the increase in the number of education grants is waived.

IV. Conclusion and Recommendation

35. In view of the overall performance and progress with the implementation of the program supported by the Public Finance and Social Sector DPL, I recommend that the Executive Directors approve the waivers referred to in paragraphs 19 and 34 above to permit the release of the second tranche. Upon such approval, the Bank will notify the El Salvador Government that the second tranche of USD 248,875,000 is available for disbursement.