

GAO

Report to the Chairman, Subcommittee
on Western Hemisphere Affairs,
Committee on Foreign Affairs, House of
Representatives

February 1991

EL SALVADOR

Aid Compensates for Economic Losses but Achieves Little Growth



143247



United States
General Accounting Office
Washington, D.C. 20548

**National Security and
International Affairs Division**

B-238726

February 15, 1991

The Honorable Robert G. Torricelli
Chairman, Subcommittee on Western
Hemisphere Affairs
Committee on Foreign Affairs
House of Representatives

Dear Mr. Chairman:

This report describes how U.S. economic assistance to El Salvador has been used and if it has achieved the intended purpose. The former Chairman, Subcommittee on Western Hemisphere Affairs, Committee on Foreign Affairs, requested this report, as well as previous related reports on accountability for aid and judicial reform in El Salvador to assist in Subcommittee oversight.

Copies of this report are being sent to the Administrator of the Agency for International Development, the Secretary of State, and the Director of the Office of Management and Budget.

Sincerely yours,

Joseph E. Kelley
Director, Security and International
Relations Issues

Executive Summary

Purpose

Since 1980, the United States has provided over \$3 billion in economic assistance to El Salvador. In June 1989, the Chairman, Subcommittee on Western Hemisphere Affairs, House Committee on Foreign Affairs, requested that GAO conduct a series of reviews on aid to El Salvador. This report discusses how U.S. economic assistance to El Salvador has been used and if it has achieved its intended purpose.

Background

In the early 1980s, U.S. interest in El Salvador was heightened as stability was threatened by a leftist insurgency. Since then, the insurgency, the 1986 earthquake, and a weak economy have exacted a tremendous cost on El Salvador's government and people. As a result, the United States has provided more economic aid to El Salvador since 1980 than to any other country in Latin America. The Agency for International Development (AID) administers the U.S. economic assistance programs in El Salvador and throughout the world.

Results in Brief

Violence associated with the continuing insurgency and damage from an earthquake have caused El Salvador to suffer \$3.6 billion in destroyed infrastructure and lost production over the past 10 years. U.S. economic aid, totaling over \$3 billion since 1980, has helped El Salvador cope with its economic difficulties by providing balance-of-payment support, rebuilding a damaged infrastructure, and compensating for decreased Salvadoran spending on social services.

By focusing U.S. assistance on a balance-of-payment program, AID has helped to stabilize the Salvadoran economy, but at a level far lower than El Salvador had experienced before the insurgency began. Economic growth rates in the 1980s were lower than AID projected and have barely kept pace with population growth, in part, according to AID, because of inappropriate Salvadoran economic policies. El Salvador has reversed previous unsuccessful economic policies by instituting significant reforms in mid-1989, which were designed to enhance exports and foreign investment. Although exports and foreign investments have been constrained by the insurgency violence, the reforms are beginning to improve economic prospects.

AID has helped El Salvador to maintain essential social services while the insurgency continues. Salvadoran health indicators have improved and literacy rates have remained static. It is likely that these indicators would have deteriorated without U.S. aid. However, limited funding and

improper allocations of Salvadoran resources have hindered the provision of needed services, particularly in rural areas. AID is encouraging Salvadoran officials to improve health and education resource allocations to better meet the social service needs of its people.

GAO's Analysis

Aid Program Compensates for Economic Damage

AID estimates that the insurgency has caused about \$2.6 billion in destroyed infrastructure and lost production, and the 1986 earthquake has caused an additional \$1 billion in damages. To cushion the economic impact of this damage, AID has provided over \$3 billion since 1980, including \$1.4 billion in cash transfers for direct balance-of-payment support. This aid, although extensive, is less than the estimated damage caused by the insurgency and the earthquake.

Aid Helped Achieve Economic Stability but Little Growth

Almost half of U.S. economic assistance to El Salvador has supported its economy by providing cash to the government of El Salvador for direct balance-of-payment support to finance imported goods. Economic trends for 1978 through 1990 show that El Salvador's economy has stabilized, but at economic levels much lower than the pre-insurgency period. For example, the per capita gross domestic product decreased by about 26 percent. AID estimated that, without U.S. assistance, the decrease would have been 45 percent. Since 1983, AID has helped El Salvador achieve modest economic growth, which has barely kept pace with population growth and is less than AID had projected.

Throughout the 1980s, AID encouraged El Salvador to reform its economic policies. In 1989, El Salvador's government initiated comprehensive economic reforms recommended by AID to develop a stable and self-sustaining economy. The reforms included currency exchange rate revisions, income tax and tariff rate changes, and actions to lessen state control of the banking system. The reforms accelerated Salvadoran negotiations with the World Bank and International Monetary Fund for needed funding arrangements. In August 1990, the Fund approved a standby financial agreement under which El Salvador could receive up to \$50 million over 12 months for balance-of-payment support. This may encourage other loans and attract foreign investment needed for economic growth.

El Salvador depends on exports to earn the foreign exchange needed to finance imports required for nearly every sector of the economy. AID has tried to diversify El Salvador's economy by encouraging exports other than the traditional coffee, sugar, and cotton. AID has also funded programs to encourage business activity and foreign investment. These efforts have achieved only limited success, largely because insurgent violence makes new economic ventures risky.

AID officials acknowledged that economic growth has been limited. However, they believe that U.S. assistance has been crucial in supporting Salvadoran democratic initiatives and social stability and in setting the groundwork for economic reforms.

Repairing Damage

AID has spent over \$233 million specifically to repair or reconstruct the infrastructure damaged by the insurgency and the earthquake. These expenditures, though essential, have generally not improved Salvadoran living standards. Rather, they have permitted El Salvador to cope with the damages by funding temporary repairs, while permanent repairs or new construction is postponed. When the insurgency subsides, El Salvador will need to invest hundreds of millions of dollars in a new infrastructure, according to AID officials.

Social Service Aid Has Filled Funding Gaps

Despite the continuing insurgency and economic decline, AID's assistance has helped El Salvador to continue funding basic social services. As a result, overall social welfare indicators have not deteriorated, and in some cases have improved. For example, infant mortality decreased from 75 deaths per 1,000 births in 1980 to less than 55 per 1,000 in 1988, and the adult literacy rate has remained roughly at the pre-insurgency levels. As the cost of fighting the insurgency increased, Salvadoran spending on health and education decreased. The share of the Salvadoran budget spent on health and education declined from 32 percent in 1979 to less than 24 percent in 1988. In fiscal year 1990, AID obligated about one-fourth of U.S. economic assistance for El Salvador to compensate for this spending decrease, thereby helping El Salvador to increase accessibility of education to children and provide for other social service needs.

Resource allocation practices within the Salvadoran Ministries of Health and Education have reduced the provision of services to the most needy. For example, AID and Salvadoran government officials indicated that the allocation of health resources does not reflect the country's basic needs.

Its major health problems are diarrhea and respiratory diseases, primarily in rural areas. However, following historical funding practices, most of El Salvador's health resources have gone for urban hospitals and administrative costs. Although primary health care would help prevent these diseases, only 22 percent of El Salvador's health funds are spent for this purpose. However, AID and El Salvador are developing a plan to direct more resources to the rural poor.

In addition, U.S.-donated food has not provided demonstrable nutritional benefits and has generally not been used to support community and self-help activities. As a result, AID has revised its food donation program.

Recommendations

GAO is making no recommendations.

Agency Comments

GAO did not obtain written agency comments. However, GAO discussed the report with responsible agency officials and has included their comments as appropriate.

Contents

Letter		1
Executive Summary		2
Chapter 1		8
Introduction	U.S. Economic Assistance to El Salvador Objectives, Scope, and Methodology	8 10
Chapter 2		12
U.S. And Salvadoran Efforts Bring Economic Stability but Little Growth	Economy Has Stabilized at Lower Levels Reasons for Economic Problems Efforts Toward Long-Term Economic Growth Conclusions	12 14 15 21
Chapter 3		22
Maintaining Social Services	Funds for Health and Education Are Limited Health Indicators Have Improved but Services Are Limited Inefficient Resource Use Has Reduced Basic Education Services Government's Strategy to Improve Social Services for the Poor Food Donation Program Changes Conclusions	22 23 25 27 28 29
Appendix	Appendix I: Major Contributors to This Report	30
Table	Table 3.1: Education of Population, Ages 6 and Older, by Residence	26
Figures	Figure 1.1: U.S. Economic Assistance to El Salvador Figure 1.2: Fiscal Year 1990 Economic Assistance Figure 2.1: Economic Growth Rates Figure 2.2: U.S. Imports From Central American Countries Figure 3.1: Government Health Expenditures 1978-87	9 10 13 19 24

Contents

Abbreviations

AID Agency for International Development
GAO General Accounting Office
GDP Gross Domestic Product

Introduction

The Agency for International Development (AID) is responsible for administering U.S. economic assistance programs in various foreign countries worldwide. In El Salvador, AID has administered economic assistance since fiscal year 1980 that will total over \$3 billion by the end of fiscal year 1991. This assistance consists of the following:

- Economic Support Fund assistance to promote economic and political stability; over three-fourths has been provided as cash transfers, and the remainder has been used to finance projects.¹
- Development assistance to finance projects in the agriculture, health, education, and other development sectors.
- Food assistance provided under the Public Law 480 (7 U.S.C. 1691) to finance subsidized agricultural commodity sales and food donations.

According to AID, U.S. economic assistance is intended to help the government of El Salvador cope with the economic consequences of a continuing antigovernment insurgency, a faltering economy, and the results of a 1986 earthquake. The insurgency has had a major adverse impact on El Salvador's economic and social structure because the continued violence has reduced business activity and investment, displaced many Salvadorans, and seriously damaged the infrastructure. According to the U.S. Government, 70,000 people have been killed as a result of the insurgency. Of the estimated population of 5.1 million in 1989, 500,000, or about 10 percent of the population, have been displaced within the country. In addition, perhaps 1 million have fled the country to avoid the conflict. This situation was exacerbated by massive earthquake damage in 1986. The earthquake caused the death of 1,500, injured 20,000, and made 300,000 persons homeless.

U.S. Economic Assistance to El Salvador

In the early 1980s, U.S. interest in Central America heightened as regional stability was threatened by an economic recession and communist insurgencies. In 1984, the Reagan administration submitted what was called the Central America Initiative to the Congress to address the recommendations of the National Bipartisan Commission on Central America.² The initiative consisted of a multi-billion dollar package of aid

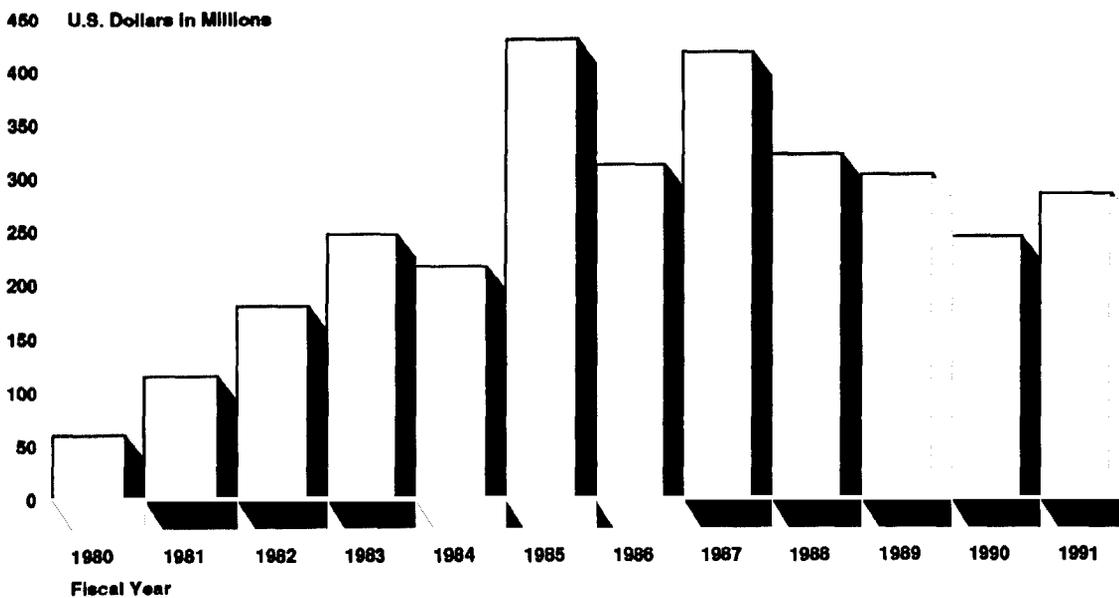
¹Appropriation legislation has required that 25 percent of Economic Support Fund aid be used to finance various projects.

²This Commission, chaired by Henry Kissinger, a former Secretary of State, was formed at the request of the President. It recommended large infusions of aid to improve economic, political, and social conditions in Central America and to support U.S. interests.

to improve economic conditions in El Salvador and other Central American countries. This assistance was to (1) promote economic and social stability and economic growth, (2) spread the benefits of growth, and (3) promote democratic institutions and processes.

As shown in figure 1.1, U.S. economic assistance peaked in 1985 and has generally declined since then. Throughout the 1980s, the size of the U.S. economic assistance program to El Salvador ranked first in Latin America.

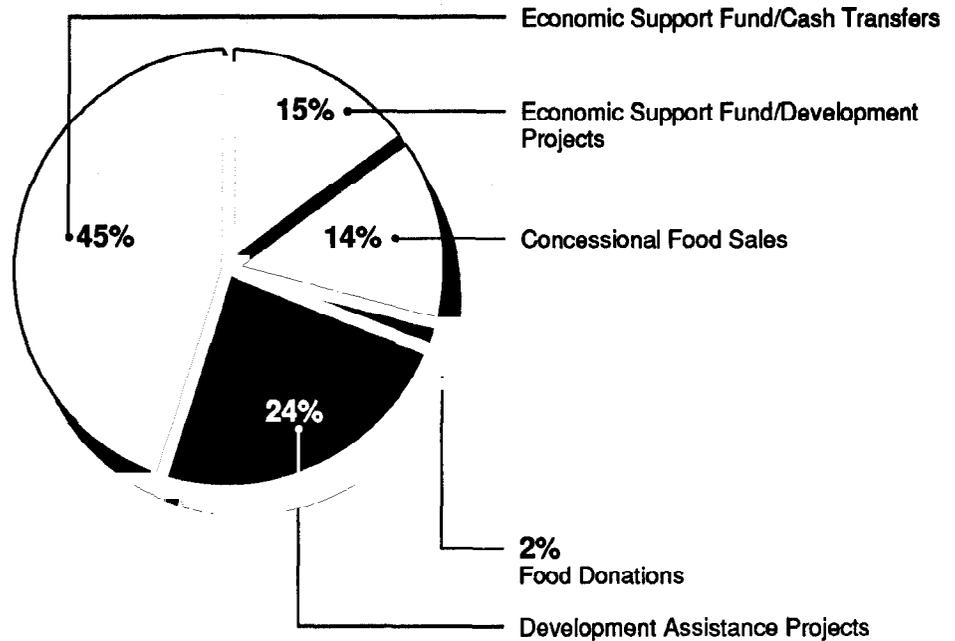
Figure 1.1: U.S. Economic Assistance to El Salvador



Note: Figures for 1990 and 1991 are estimates
Source: Agency for International Development

Figure 1.2 shows how AID applied \$243 million in fiscal year 1990 economic assistance to El Salvador. Over the last 11 years, the application of U.S. economic assistance has differed little from the 1990 application.

Figure 1.2: Fiscal Year 1990 Economic Assistance



Source: Agency for International Development

Objectives, Scope, and Methodology

In June 1989, the Chairman, Subcommittee on Western Hemisphere Affairs, House Committee on Foreign Affairs, requested that we conduct a series of reviews on (1) U.S. aid to El Salvador's judicial system,³ (2) the controls and accountability for U.S. aid to El Salvador,⁴ and (3) the use of U.S. economic assistance in El Salvador and the success AID has achieved in meeting its goals. This report focuses on the Chairman's third area of interest on the use of aid to El Salvador.

We performed work in Washington, D.C., at the Department of State and AID, where we interviewed officials and reviewed audits, cables, and evaluation reports on assistance programs in El Salvador. We discussed aspects of our work with officials at the World Bank, the Inter-American Development Bank, and the International Monetary Fund. We also met with economists from the Departments of Agriculture and the Treasury.

³Foreign Aid: Efforts to Improve the Judicial System in El Salvador (GAO/NSIAD-90-81, May 1990).

⁴El Salvador: Accountability for U.S. Military and Economic Aid (GAO/NSIAD-90-132, Sept. 1990).

In El Salvador, we met with government officials of the Ministries of Planning, Economy, Education, and Health. We also met with officials of the Central Bank, representatives of business associations, officials of private voluntary organizations, and members of farm cooperatives. At the AID mission, we met with staff responsible for planning and managing assistance projects and programs. We also reviewed AID and Salvadoran program documents to determine how U.S. assistance was used. We did not independently verify data provided by AID or the government of El Salvador.

Our work was done between February and September 1990 with fieldwork done in El Salvador between April and August 1990. We did our work in accordance with generally accepted government auditing standards.

We did not obtain written agency comments, but we discussed a draft of this report with AID officials and incorporated their comments as appropriate.

U.S. and Salvadoran Efforts Bring Economic Stability but Little Growth

AID's program has emphasized efforts to achieve economic stability and growth. According to AID, economic growth is essential to achieving increased employment opportunities and improving the Salvadoran government's ability to finance social programs. AID has funded cash grants for balance-of-payment assistance to bolster the economy, private sector projects to promote business activity and investment, and construction projects to repair and replace damaged infrastructure. It measures the overall impact of this assistance by tracking macroeconomic indicators such as the gross domestic product (GDP).¹ This aid has helped stabilize El Salvador's economy by curtailing the downward economic spiral experienced in the early 1980s. Though stabilized, the economy has grown very little since 1983. In fact, the modest growth since then has barely kept pace with population growth, and increases in per capita GDP have been negligible.

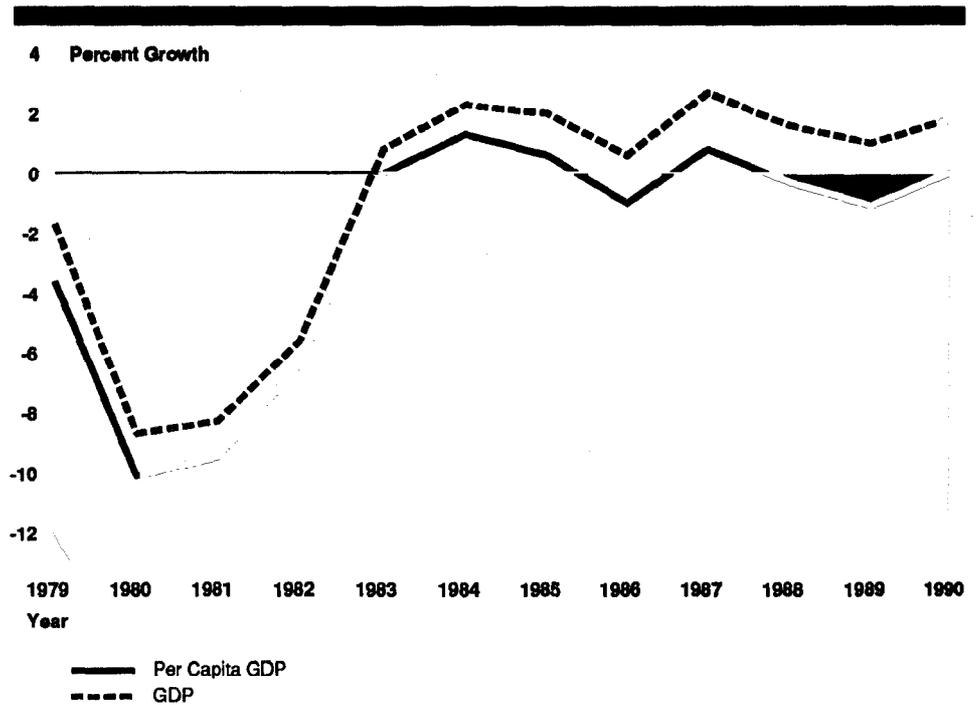
Throughout the 1980s AID has encouraged El Salvador to reform its economic policies to promote growth. Accordingly, the Salvadoran government initiated significant reforms in 1989 to increase exports and attract foreign investors. These reforms have led to improved status with international lenders and show promise for improving El Salvador's battered economy.

Economy Has Stabilized at Lower Levels

Because of U.S. economic assistance, El Salvador's economy has managed to survive, but not at desired growth rates of about 3 percent. From 1960 to 1978, El Salvador's real per capita GDP increased at an average annual rate of 2.9 percent. Between 1979 and 1983, the country was rocked by guerrilla violence and other factors that caused a sharp economic decline. Real per capita GDP declined by one-fourth from 1979 through 1983 and then stabilized with near zero growth, as shown in figure 2.1.

¹The value of total output of goods and services produced.

Figure 2.1: Economic Growth Rates



Source: Agency for International Development

Since 1980, \$1.4 billion, or 46 percent, of U.S. economic assistance to El Salvador supported the economy by providing direct balance-of-payment support. For example, in fiscal year 1990, the United States provided \$108.3 million in Economic Support Fund cash grants to help El Salvador pay for needed imports. In addition, concessional food sales through Public Law 480 have provided indirect balance-of-payment support.

This aid lessened EL Salvador's economic downturn. According to a 1989 AID report, U.S. economic assistance curtailed a downward spiral in El Salvador's real GDP and real income. AID compared actual economic performance to projected performance without U.S. assistance. Between 1978 and 1988, real per capita GDP decreased by 26 percent from \$1,279 to \$942, and real income decreased 31 percent from \$3,811 to \$2,626. The analysis projected that without U.S. assistance the rates of decrease would have been 45 percent and 49 percent, respectively.

AID officials acknowledged that economic growth rates have not met AID and Salvadoran expectations reflected in their economic and program plans. For example, in early 1986, AID said it would help to stimulate

economic growth rates, which would exceed the population growth rate, thereby achieving a positive change in per capita GDP. However, per capita GDP growth was -0.3 percent in 1988, and -1.1 percent in 1989. Nevertheless, AID believes that its assistance has contributed to social stability, promoted democratic processes, and set the groundwork for economic reforms.

Reasons for Economic Problems

El Salvador's recent economic indicators point to an economy still in difficulty. For 1989, per capita GDP decreased by an estimated 1 percent to about \$1,023, and inflation was estimated at 17.6 percent. Internal factors, such as continuing violence and past economic policies, have not been conducive to a healthy, growing economy. External forces, such as the declines in coffee prices and trade among the Central American countries, have also had a negative impact on the Salvadoran economy. Following are some of the reasons for El Salvador's economic problems:

- The antigovernment insurgency has exacted a tremendous economic cost. In 1989, the effort of containing the insurgency resulted in a defense budget that absorbed about 21 percent of the Salvadoran national budget totaling 3,715 billion colones, the equivalent of \$618 million, compared to about 10 percent in 1979. According to AID, the cost of maintaining a military and security force of 57,000 and other costs associated with the insurgency, such as Salvadoran expenditures to repair damaged infrastructure, absorbed roughly one-half of the country's public resources. According to AID, the insurgency has cost El Salvador almost \$2.6 billion in damaged infrastructure and lost productivity.
- AID estimated that El Salvador suffered \$1 billion in damages and lost productivity as a result of a 1986 earthquake. The cost includes damages to electrical facilities, buildings, bridges, roads, and other vital public services.
- Lowered foreign and domestic private investment in the economy and poor international image have cost El Salvador monetarily and have put the country at a disadvantage in the world marketplace.
- Until mid-1989, the Salvadoran government had not made significant progress toward reforming its economic policies. We reported in 1985 that AID was unable to influence El Salvador to make necessary economic reforms despite millions of dollars in U.S. aid.² In addition to not making certain fiscal reforms, El Salvador had not achieved a unified

²Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task (GAO/NSIAD-85-82, July 1985).

and realistic exchange rate and lacked a financial support arrangement with the International Monetary Fund.

- El Salvador's economy suffered as coffee prices declined in the 1980s. According to AID, El Salvador depends on coffee exports for over one-half of its foreign exchange earnings and is more dependent on coffee exports than any other country in the world. AID estimates that El Salvador would have earned an additional \$1.9 billion in foreign exchange from coffee sales, from 1980 to 1987, if prices had remained at pre-1980 prices.
- El Salvador, which benefitted from trade within the Central American Common Market, suffered as regional trading declined in the 1980s. Salvadoran exports to other Central American countries and Panama fell from \$184 million in 1983 to \$129 million in 1988.

Efforts Toward Long-Term Economic Growth

AID's program emphasizes actions to promote long-term economic growth. In mid-1989, with AID support, El Salvador initiated a comprehensive economic reform effort that may help the country gain access to international financial markets, thereby providing it with much needed capital. AID believes that its efforts throughout the 1980s to influence economic policies and increase dialogue between the public and private sector were, in part, responsible for these Salvadoran initiatives. AID has also tried to help El Salvador reduce its dependence on coffee exports as a major source of foreign exchange. Although facing serious constraints, El Salvador is attempting to increase investment and obtain other donor assistance.

Economic Reforms Improve Prospects

At the time of our fieldwork, El Salvador was already realizing some benefits from the economic reforms in 1989 as part of the Salvadoran government's 5-year plan for economic reform and social development. The plan specified the steps necessary for economic reform and set goals for growth of GDP, consumption, and exports to achieve sustained economic improvements. The plan calls for measures to (1) unify the exchange rate, using newly created exchange houses; (2) make major changes to the import and export laws; (3) change the banking system from public to private control; (4) sell government-owned businesses to the private sector; (5) reform the tax code; and (6) reduce the budget deficit. These measures are in various stages of implementation.

A 1989 AID analysis projected that these Salvadoran economic policy reforms could increase the real per capita GDP by 8.7 percent from 1990 to 1994. Although the full effects of these reforms are not evident yet,

AID officials said there have been some improvements. Some exports have increased as a result of a more realistic exchange rate policy, which has partially corrected an overvalued local currency. For example, exports of nontraditional goods, such as textiles, fruits and vegetables, increased from \$31.3 million from January to May 1989 to \$50.4 million for the same period in 1990.³

According to AID officials, El Salvador was reluctant to undertake economic reforms earlier because the government feared adverse internal political reactions and short-term economic consequences. AID officials are concerned that the tense and sometimes volatile situation in El Salvador may jeopardize the current reform effort. According to AID officials, continued reforms depend on the will of the Salvadoran President and the National Assembly to change applicable laws and ensure that the reforms are fully implemented. AID officials also cautioned that some of the reforms would involve fiscal austerity that could result in less funding for government programs that help the poor.

Economic Reform May Make More Loans Available

El Salvador's economic reforms are expected to attract other donor assistance to El Salvador, which according to AID officials, could offset diminishing levels of U.S. assistance. Since mid-1989, when reforms were initiated, both the World Bank and the International Monetary Fund have discussed new loans with El Salvador. Pending multilateral loans could amount to as much as \$1.1 billion over the next 4 years.

In July 1990, El Salvador had two loans pending with the World Bank: a \$30-million balance-of-payment loan to support its economic reform process and a \$20-million loan to rehabilitate social service facilities. A World Bank representative told us that disbursement of these loans may begin in 1991. According to AID, the World Bank is also negotiating a \$75 million loan to support the economic reform process.

In August 1990, the International Monetary Fund approved a standby arrangement that allows El Salvador to receive up to \$50 million of balance-of-payment support over the next 12 months to help the country's economic and financial program. The economic program supported by the arrangement is aimed at strengthening El Salvador's balance-of-payment position while El Salvador works to lower its inflation rate, which was about 17 percent in 1989. Funding provided by the arrangement is tied to El Salvador's progress in reforming its economic policies. Because

³El Salvador's traditional exports are coffee, cotton, and sugar.

many financial institutions, including the World Bank, link their loans to Fund actions, an "economic seal of approval" from the Fund may offer El Salvador more access to credit from other international financial institutions, private banks, and businesses.

While the United States is the largest donor, the Inter-American Development Bank has been El Salvador's second largest source of economic assistance. According to a Bank official, the Bank and El Salvador have identified 16 projects totaling \$952 million for funding between 1990 and 1993. The majority of these projects will focus on social development, emphasizing needs of the rural poor. The United States has contributed roughly one-third of the Bank's resources.

Efforts to Increase Exports

AID and El Salvador consider increased exports to be essential to achieving economic growth. Imports are necessary for nearly all facets of El Salvador's industry. Along with U.S. aid, El Salvador depends on exports to generate hard currency to pay for its imports. To lessen El Salvador's dependence on coffee as the major means of earning hard currency, AID and El Salvador have encouraged nontraditional exports from the agriculture and manufacturing sectors.

We identified seven AID projects to encourage production and growth of nontraditional agricultural products and industrial goods for export. Since 1984, AID has allocated more than \$119 million to these projects. As of March 1990, \$74 million of these funds remained to fund future project activities. Most of the unexpended funds were intended to develop a free trade zone facility and to provide loans for agribusiness ventures.

In the short-term, economic reform has had a negative impact on some of these projects. For example, the reform has caused the local currency to decline in value relative to the dollar. As a result, agribusiness borrowers must spend more local currency to repay dollar loans. In addition, the poor investment climate has reduced the demand for credit by agribusiness borrowers. As a result, about \$11 million in available credit has not been used. The free-trade zone development project has about \$26 million in unspent funds. A proposed loan to construct a zone has been delayed because of the increased interest rate brought about by the economic reforms. AID and El Salvador have discussed some type of a short-term concessional interest rate to encourage a developer to undertake the construction.

Despite these problems, AID believes that El Salvador's economic reforms may help provide an environment that will encourage exports. The country has adopted a flexible currency exchange rate. In the past, the currency was overvalued, but now the market determines the exchange rate. According to AID, this policy change will increase financial incentives to Salvadoran exporters and make Salvadoran exports more competitive in world markets.

Obstacles to Agricultural Exports

Four private sector projects were initiated by AID several years ago to encourage production of nontraditional agricultural products, such as fresh fruits and vegetables, for export. They have had limited success; however, according to AID, it may be too soon to expect significant results from these projects.

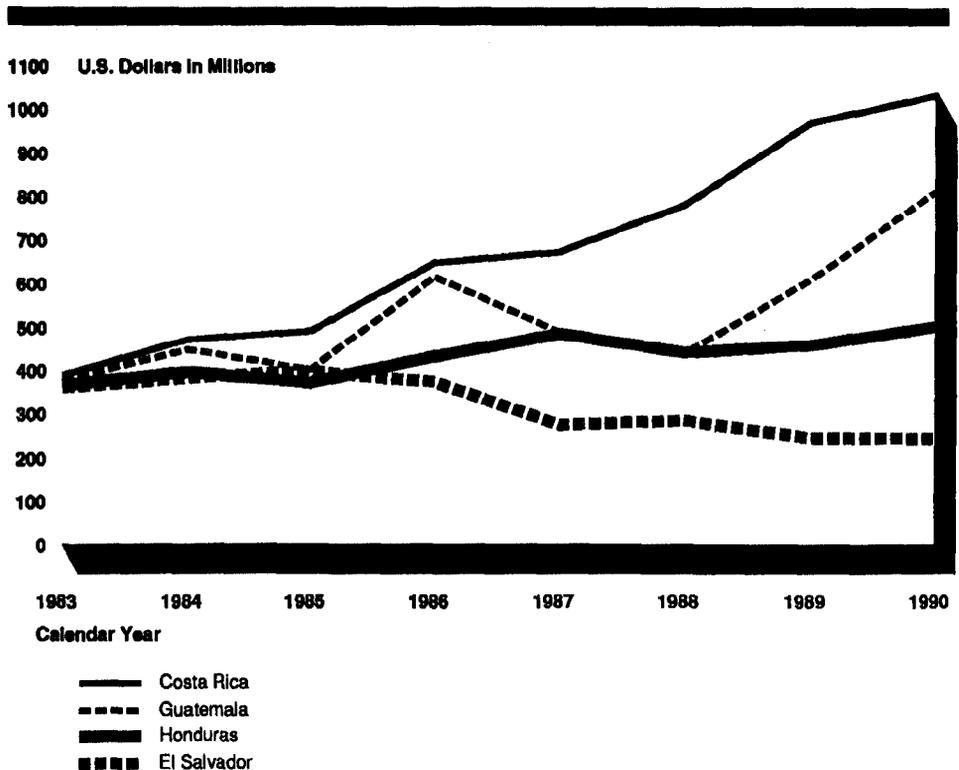
Significant barriers remain for increased nontraditional agricultural exports. According to AID, El Salvador lacks a tradition of producing fruits and vegetables for local consumption. Such production has been a basis for building an export business in other countries. Also, Salvadoran growers are aware of the increased risks, both in production and marketing, of exporting nontraditional agricultural products. These exports have also been hampered by lack of technical assistance to farmers. A 1989 study by the National Cooperative Business Center found that only 6.5 percent of Salvadoran farmers received technical assistance. Since the government has limited resources, AID has undertaken projects to provide technical assistance through local and U.S. private voluntary organizations. In addition, many farmers are at a disadvantage because they are illiterate. Lack of technical assistance and illiteracy affects the ability of farmers to adapt to new crops and agricultural methods. Also, a decade-old agrarian reform program created cooperative farms that are in poor financial condition. The Salvadoran government, after compensating landowners with cash and bonds, expropriated and transferred land to farmer cooperatives. These cooperative farms have had difficulty obtaining financing to develop nontraditional export crops because of their existing debt and the inexperience of financial institutions in lending for nontraditional crops.

Obstacles to Non-Agricultural Exports

Serious obstacles also constrain exports of manufactured goods. Manufacturing activities are hampered because the 1986 earthquake destroyed factory and office space, and the insurgency has damaged the country's infrastructure. Money for reconstruction has been limited because of the insurgency. Also, El Salvador faces stiff competition from

other Central American and Caribbean countries in its efforts to increase exports to the United States. As shown in figure 2.2, El Salvador has not been able to match the success of its Central American neighbors in increasing exports.

Figure 2.2: U.S. Imports From Central American Countries



Note: 1990 figures are projected based on January to October 1990 data
 Source: U.S. Department of Commerce

Efforts to Improve Investment

By encouraging economic reforms, AID attempted to attract foreign investment and keep local investment capital in El Salvador. Foreign and local investments contribute to the country's ability to expand its economy and increase exports.

Annual total foreign business investment peaked in 1979 at \$23.1 million. However, investors' confidence sagged as the insurgency intensified. By 1983, new direct foreign investment was virtually zero and total investment was only about \$6.7 million.

Recognizing the shortage of capital for investment, especially in non-traditional export enterprises, AID funded several specialized lines of credit, starting in the mid-1980s. New direct foreign investment has increased, and in 1988 it was \$3.3 million, the highest since 1979. However, total investment in 1988 was only about \$5.4 million, or about \$18 million less than 10 years earlier.

The problem of low investment levels is compounded by El Salvador's large outflow of capital. According to recent U.S. government estimates, El Salvador experienced a net private capital outflow of about \$275 million from 1986-88. This amount is equivalent to about one-fourth of the U.S. economic aid for that period. According to an AID economist, in 1990 El Salvador had an inflow of capital, reversing the past outflow trend.

Repairing Damage

A portion of AID's assistance program has been spent on rebuilding infrastructure damaged by the insurgency and the earthquake. These rebuilding activities are essential to economic and social stability. But because they are designed to repair damage rather than improve El Salvador's infrastructure, these rebuilding activities have not been effective in improving living standards. Many repairs are temporary, and permanent repairs or replacement is postponed. These temporary repairs affect reliability and increase the costs of keeping the infrastructure in operation.

El Salvador spends a considerable portion of its resources to repair and protect the infrastructure from war-related damage. In addition, through fiscal year 1990, AID spent about \$233 million for infrastructure repair and reconstruction-related projects. This includes

- \$158 million to restore public services such as electricity, bridges, and schools damaged by guerrilla attacks and
- \$75 million to repair and replace buildings damaged or destroyed by the 1986 earthquake.

According to AID officials, El Salvador's infrastructure is in bad condition despite AID funding of temporary repairs, and El Salvador will have to invest millions of dollars for new construction when the insurgency subsides.

Importance of Ending Violence

Economic growth has been inhibited by inappropriate Salvadoran economic policies and continuing violence. The Salvadoran government has initiated economic reforms; however, the insurgency remains an obstacle to implementing the reforms, attracting investment, and increasing exports, which are necessary for economic growth. AID and Salvadoran officials stressed the importance of ending the violence as the principal achievement needed to permit development activities to succeed.

Salvadoran industry officials were not optimistic that full economic reform was possible while the country is engaged in a violent guerrilla conflict. According to Salvadoran government officials, the short-term effects of economic reform have a negative impact on the poor, which, if not countered, can lead to social and political unrest. Attempts to alleviate the impact of economic reforms have been limited because of the resources that must be set aside to fight the insurgency.

According to AID, an end to the war would have substantial positive benefits. Economic reforms would be easier to successfully implement, and investors may find El Salvador a more attractive and stable place for investment. For example, the insurgency and the earthquake have created a shortage of office and factory space in El Salvador, which has made it difficult to expand industry for production of goods for export. Also, the capability of El Salvador's seaports to handle exports and imports has been seriously degraded by damage to dock crane motors and controls caused by guerrilla sabotage of the power grid. AID is assisting El Salvador in building more space for export-related industry, which will help the shortage of factory space. An end to the insurgency would make more resources available to repair and upgrade the seaports. The capital flight trend may also be reversed, which would provide more funds for internal investment. Increased foreign and domestic investment would provide a boost to the economy.

Conclusions

U.S. economic assistance has helped El Salvador to stabilize its economy. Continued violence and other factors have detracted from AID and Salvadoran efforts to promote exports and overall business activity. As a result, El Salvador's economic growth rates have been less than AID projected. By initiating economic reforms, El Salvador has improved prospects for achieving higher growth rates in the future.

Maintaining Social Services

Despite the decade-long insurgency and its economic problems, El Salvador, with AID's assistance, has managed to maintain or improve social welfare indicators. In fiscal year 1990, AID obligated over 25 percent of economic assistance for social programs. While some social indicators have improved, such as the rates of infant mortality and malnutrition, adult literacy has not improved, and government cutbacks have limited delivery of health and education services to the rural poor. Poor allocation of resources within the Ministries of Health and Education have added to problems in these social sectors. AID and El Salvador are working to improve health and education services through programs aimed at preventive health care and basic education in rural areas. In addition, AID is revising its food donation program.

Funds for Health and Education Are Limited

As the cost of El Salvador's insurgency escalated in the 1980s, public spending shifted from health and education to defense. In 1979, the government spent 32 percent of its budget on health and education and 10 percent on defense. By 1988, health and education accounted for less than 24 percent of the budget, with defense at over 21 percent.¹ This change has reduced the ability of the Ministries of Health and Education to pay salaries and other program costs. Salvadoran ministry officials said they have been able to maintain health and education services only because of the external assistance provided by the United States and other donors.

The result of public spending on health and education is best illustrated in urban poor and rural areas where health supplies and materials are insufficient and where there is a teacher shortage. For example, we visited an urban health facility that had enough medicines to last only 2 months. A rural health worker said that she did not have sufficient resources to educate rural people about preventive health care. Additionally, of six rural schools we visited, five did not have enough teachers for afternoon classes, thereby limiting the number of children who could attend. One school principal said that new students had to be admitted on a first-come, first-served basis.

¹Excludes U.S. aid.

Health Indicators Have Improved but Services Are Limited

The health of Salvadorans has improved despite budget cutbacks. Overall, statistics show that infant mortality and malnutrition in children have decreased. Improvements have been greater in urban areas than in rural areas. El Salvador's health programs can be improved with better allocation of resources between urban and rural areas. AID, in conjunction with the Ministry of Health, is working to provide more efficient health care to poor Salvadorans by emphasizing preventive health care in rural areas.

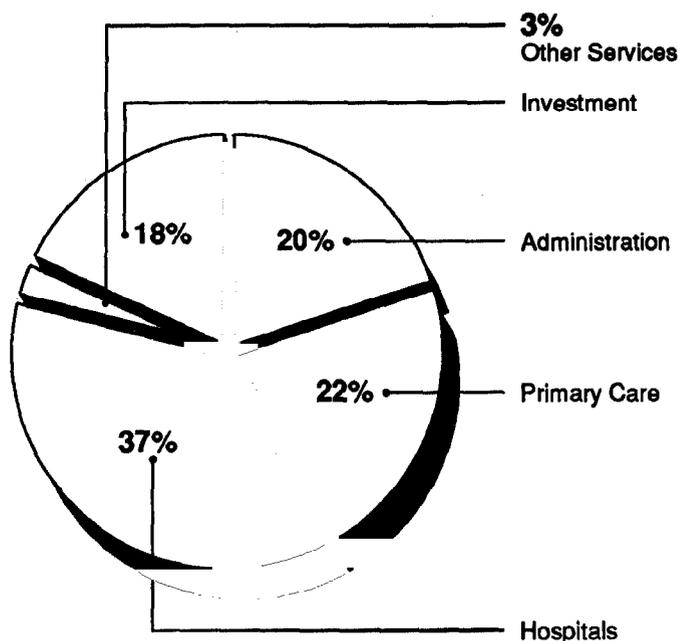
While the health status of Salvadorans as a whole has improved, the situation is not so positive in rural areas. Infant mortality for El Salvador overall decreased from 75 deaths per 1,000 births in 1980 to between 50 and 55 per 1,000 in 1988. The percentage of malnutrition cases in children under age 5 decreased from 18 percent in 1977 to 15.4 percent in 1988. However, health conditions in rural areas, where more than one-half of the population lives, are worse than in the country as a whole. For example, for every 1,000 live births in rural areas, 61 children die within their first year. In addition, only 16 percent of the rural population has access to safe drinking water. According to a Ministry of Planning report, the poor health status of Salvadorans has resulted partly from the inefficient use of the Ministry of Health's resources. Both material and financial resources are inefficiently allocated between urban and rural health care.

Poor Allocation of Resources

Services within the Ministry of Health are not allocated to reach those who need help most—poor Salvadorans in rural areas. Most Ministry of Health resources are concentrated in large urban hospitals, rather than in small rural health posts where preventive care could be taught. Of 342 health facilities operating in El Salvador, 203 are small rural health posts where care is limited to services such as providing bandages and aspirin and making referrals to hospitals. As shown in figure 3.1, Primary health care² accounted for 22 percent of El Salvador's health expenditures between 1978 and 1987, while hospitals accounted for 37 percent, according to the Salvadoran Ministry of Health. According to AID, misallocation of health resources is common in less developed countries.

²Routine health services which emphasize preventive care.

Figure 3.1: Government Health Expenditures 1978-87



Source: El Salvador Ministry of Health

The concentration of resources in large urban hospitals does not address the country's basic health problems of diarrhea and respiratory diseases, especially among women and children in rural areas. The Vice Minister of Health told us that these illnesses could be prevented through better sanitation and primary health care services in rural areas. He believes that the government spends too much to operate urban hospitals rather than preventing health problems in rural areas. A 1990 government report concluded that poor resource distribution had contributed to the failure of the government's health care system to reach rural areas. AID officials indicated that the insurgency has also impeded the government's capacity to deliver health services to the rural areas.

Efforts to Improve Use of Health Resources

El Salvador's progress in making health improvements is largely due to U.S. economic aid. Between 1984 and 1990, the United States provided over \$287 million for health programs. U.S. health assistance funds are used to purchase medicines, medical supplies, and equipment. According to the Vice Minister of Health, without U.S. assistance the health situation in El Salvador would have most likely deteriorated.

A major overhaul of the Ministry of Health has begun, which will address internal inefficiencies, redirect resources to primary health care services, and decentralize health services. AID has provided the Ministry of Health with \$600,000 in computer equipment to improve internal control over pharmaceutical and medical supplies. In addition, starting in 1988, AID shifted its focus from general institutional support to direct support for basic services to high-risk groups, mainly children under age 5 and women in rural areas. In the future, specific emphasis will be placed on vaccinations, prenatal care, health and nutrition education, and potable water availability.

El Salvador also plans to improve primary health care in rural areas. The government plans to conduct prenatal and postnatal checkups and well-baby care at rural health facilities. Decentralization of health services will also be initiated, giving more responsibility for primary health care and prevention to the local community. The Vice Minister of Health said that the objectives of decentralization are to have patients enter at the lowest preventive care level and use a referral system for the more serious cases. At the time of our fieldwork, it was too early to assess whether these strategies would be effective.

Inefficient Resource Use Has Reduced Basic Education Services

Literacy rates have not improved since 1978, and according to AID, the provision of basic education to the rural poor has been hampered by the insurgency and inefficient use of resources by the Ministry of Education. Until recently, AID funds have been used primarily for school construction and supplies. AID is now focusing on improving management, instructional materials, and teacher training.

Little Improvement in Education Indicators

The education system in El Salvador experienced a period of improvements before 1978. According to AID, literacy rates rose from 51 percent in 1960 to 62 percent in 1978, during which time the Ministry of Education was receiving up to one-fourth of the public budget. However, since 1978, literacy rates have not improved, and the Salvadoran expenditures for education decreased to 15 percent of the budget in 1990. In addition, a government study found that the urban population, on average, completes 6 years of school, while the rural population completes only 3.1 years. In some poor regions, the adult literacy rate is less than 55 percent.

Education levels for rural areas is less than for urban ones. For example, as shown in table 3.1, about 86 percent of the urban population, ages 6

and older, in the city of San Salvador have some formal education, but 75 percent of the population in other urban areas and only 53 percent of the rural population have some formal education.

Table 3.1: Education of Population, Ages 6 and Older, by Residence

Education level	San Salvador (percent)	Other urban (percent)	Rural (percent)
No education	14.1	24.7	46.6
Some elementary	43.7	49.5	46.4
Some high school	31.5	22.8	6.7
Some college	10.7	3.1	0.2

Source: February 1990 AID study.

Beginning in 1982, U.S. aid for education increased with the rebuilding or construction of schools and the provision of materials, which subsequently led to the reopening or opening of approximately 323 schools. Despite this investment, AID estimates that about 640,000 primary school-aged children lack access to formal education.

Poor Resource Allocation Plagues Education

In El Salvador, as in other less developed countries, internal management weaknesses contribute to inefficiencies in education. For example, a 1990 Salvadoran government report said that, of about 24,700 Ministry of Education employees hired as teachers, only 16,700 were actually teaching. The remaining 8,000 were in non-teaching positions.

According to the Minister of Education, budget resources and teaching staff are not sufficient to provide educational supplies and teachers needed in rural areas. According to a 1989 AID study, the Ministry of Education uses about 95 percent of its funds to pay salaries, which is common in less developed countries. The Minister stated that the lack of incentives to attract teachers to rural areas and noncompetitive salaries are factors in staffing classrooms. Teachers in public schools work split-sessions between the morning and afternoon. One principal told us that most of the school's teachers work in the morning and subsidize their income by teaching in private schools during the afternoons. The principal said that if he had teachers to fill three empty classrooms in the afternoon, 150 more children could attend school.

Improvements Planned for Basic Education

AID has been instrumental in increasing the accessibility of education to children, especially in rural areas. AID's education revitalization project provided over \$30 million to construct and reconstruct classrooms and

to purchase school supplies and equipment. This project resulted in the opening or reopening of about 2,800 classrooms, some of which had been destroyed by guerrilla sabotage. In addition, over \$27 million of AID's earthquake reconstruction funds was used to construct or repair 1,937 classrooms and education facilities damaged by the quake. In fiscal year 1989, AID expended \$36 million for education and human resource development.

In early 1990, AID proposed a 5-year, \$27.8-million project to improve management, instructional materials, and teacher training for basic education. AID believes that basic education is important for economic, social, and political reasons. The new Salvadoran administration has also made basic education a priority. El Salvador plans to target resources to basic education in rural areas and adult education programs. However, significant educational improvements will require more funds. According to the Vice Minister of Planning, the availability of needed funds for education depends on El Salvador's economic progress. Its progress, in turn, depends on the success of economic reforms and an end to the violence, which is a drain on government resources.

Government's Strategy to Improve Social Services for the Poor

In the wake of aggressive economic reforms discussed in chapter 2, El Salvador, with AID's assistance, has developed a social strategy to minimize the adverse impact of the economic reforms on the poor. El Salvador designed the strategy to provide resources to meet basic needs such as jobs, education, health, and shelter for low-income groups. For example, the government's housing program is expected to give priority to the construction of low-cost housing and housing subsidies so that affordable housing is available to the poor.

AID and El Salvador have agreed on the need to cushion the negative effects of the economic reforms on the poor. AID's strategy is to expand on existing labor-intensive projects that are already being implemented through AID and Salvadoran programs. El Salvador and AID rely on activities and programs, including municipalities in action, displaced persons, and public services restoration projects. For example, the municipalities in action program provides funds to communities to build infrastructure based on local needs. All of these programs are at least partially funded with U.S. aid. According to AID, the efforts taken by both AID and El Salvador will provide the country with needed public works and will generate short-term employment for the population to sustain themselves until the economy improves. However, some government officials

are concerned that available resources may be insufficient to provide essential services and jobs.

Food Donation Program Changes

Between 1980 and 1991, the United States allocated about \$86 million in food aid for El Salvador under the Public Law 480 title II food donation program. For fiscal year 1990, 12,158 metric tons of food, worth about \$5 million, were donated to El Salvador for distribution to needy Salvadorans by Catholic Relief Services, a U.S. private voluntary organization, and the National Commission for Area Restoration, a Salvadoran government organization. Concerned that this food aid has not had a demonstrable impact on the recipients' nutritional welfare, AID is assisting Catholic Relief Services in improving its program monitoring and evaluation process. AID is also halting food distributions through the Salvadoran government in conjunction with civic actions supported by the Salvadoran military.

Under title II, the United States provides food donations to help foreign countries meet various emergency relief and community development requirements and to combat malnutrition. The authorizing legislation requires that program managers consider the nutritional needs of the food recipients and, to the extent feasible, that those suffering from malnutrition and living in the poorest regions receive priority in the distribution of food. The law also requires that, to the extent practical, title II aid be directed toward community and other self-help activities that would ultimately alleviate the need for or dependence on donated food. AID's policy is to encourage programs that promote economic and social development, in addition to overcoming malnutrition.

In 1990, Catholic Relief Services distributed \$3.8 million of food to an estimated 120,000 low-income and undernourished mothers and children. An AID-funded evaluation report noted no significant difference in nutritional levels between program recipients and non-recipients. AID officials told us that they are helping the organization to measure feeding program results more effectively to determine if the program should continue. For example, AID provided a \$70,000 grant to purchase new weight scales and educational materials to complement the food distribution program. Catholic Relief Services staff plan to use the scales and growth charts to measure health conditions in children. Also, Catholic Relief Services staff are scheduled for training to better detect nutritional problems such as inadequate weight gain, and to teach mothers about health, including the treatment and control of diarrhea. AID plans a follow-up evaluation of the program in 1991.

The National Commission for Area Restoration, referred to as CONARA, distributes food to needy people living in areas of guerrilla activity. Government personnel distribute food during "combined civic actions," while Salvadoran military forces provide security and dispense medical and dental care. For 1990, AID allocated \$1.1 million of U.S.-donated food to El Salvador's government for distribution to about 24,000 families.

Food is targeted to geographic areas where adequate food supplies may not be available. As of June 1990, these food distributions were not being used in conjunction with other development programs. Food distributions, in which families receive food rations for one month, have been sporadic, and a family usually gets only one ration a year. During the first 7 months of 1990, 97 percent of the communities receiving food donations received a donation only once. An AID evaluation of the combined civic action program concluded that, at best, the food distribution program encourages the recipients to view the military in a positive light. However, because of their infrequency, these food distributions have not improved the nutritional status of recipients.

In September 1990, AID indicated that they would discontinue funding food donations distributed by the government of El Salvador during combined civic actions. Instead, AID planned to provide food to be used as part of the municipalities in action program for the poorest of selected municipalities. However, the U.S. Agricultural Trade and Development Act of 1990 did not include foreign governments as organizations eligible to receive title II non-emergency assistance. As a result, AID's 1991 title II food assistance program for El Salvador will be limited to activities of the Catholic Relief Services.

Conclusions

U.S. aid for Salvadoran social programs, which accounts for about one-fourth of the U.S. economic aid to the country, has helped to compensate for decreased Salvadoran spending. AID is encouraging El Salvador to improve its use of limited resources allocated to the social service sectors to maximize services available to the most needy. In conjunction with El Salvador, AID has developed a social services strategy to provide jobs and public works projects until the economy improves. AID has revised its food donation program.

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