

El Salvador

Building on Strengths for a New Generation

Systematic Country Diagnostic

Oscar Calvo-Gonzalez
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Abbreviations

ARENA	<i>Alianza Republicana Nacional</i> (National Republican Alliance)
ATM	Automated Teller Machine
CAPRA	Central America Probabilistic Risk Assessment
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women
CEMLA	<i>Centro de Estudios Monetarios Latinoamericanos</i> (Latin American Monetary Studies Center)
CEPAL	<i>Comisión Económica para América Latina</i> (ECLAC in English)
CGE	Computable General Equilibrium
DIGESTYC	<i>Dirección General de Estadísticas y Censos</i> (General Directorate for Statistics and Censuses)
ECLAC	Economic Commission for Latin America and the Caribbean (<i>CEPAL</i> in Spanish)
EHPM	<i>Encuesta de Hogares de Propósitos Múltiples</i>
FDI	Foreign Direct Investment
FMLN	<i>Frente Farabundo Martí de Liberación Nacional</i> (National Liberation Front Farabundo Martí)
GDP	Gross Domestic Product
GMM	General Method of Moments
GoES	Government of El Salvador
GTAP	Global Trade Analysis Project
ILO	International Labor Organization
IMF	International Monetary Fund
IT	Information technology
IUDOP	<i>Instituto Universitario de Opinión Pública</i> (Public Opinion University Institute)
LAC	Latin America and the Caribbean
LAPOP	Latin America Public Opinion Poll
MDG	Millennium Development Goal
MAPAS	<i>Monitoreo de los Avances de País en Agua Potable y Saneamiento</i> (Monitoring of Country Progress in Drinking Water and Sanitation)
SCD	Systematic Country Diagnostic
SERCE	Second Regional Comparative and Explanatory
SIEPAC	<i>Sistema de Interconexión Eléctrica de los Países de América Central</i> (Electricity Interconnection System for the Countries of Central America)
SME	Small and medium enterprise
PPP	Public Partnership Program
TIMSS	Trends in International Mathematics and Science Study
UN	United Nations
UNESCO	United Nations Educational, Scientific and Cultural Organization

UNDP	United Nations Development Program
UNFPA	United Nations Population Fund
UNISDR	United Nations International Strategy for Disaster Reduction
UNODC	United Nations Office of Drug and Crime
US	United States of America
USAID	United States Agency for International Development
USG	United States Government
VAT	Value Added Tax
WHO	World Health Organization

Overview

FOLLOWING THE DISASTROUS YEARS of the civil war during the 1980s, the early 1990s brought peace to El Salvador. With a population of approximately 6.3 million and per capita GDP of US\$7,760 (in purchasing power parity terms) in 2013, El Salvador is the smallest country of Central America and one of the most densely populated in the Western Hemisphere. Gross inequalities in wealth and income built up in the early part of the 20th century, and historical dissatisfaction with land inequality severely exacerbated social tensions during the 1970s, at a time when the country's political system was ill-equipped to deal with these tensions. A series of confrontations between peasant and organized labor groups and the government led to increasingly repressive government responses over the decade. In the late 1970s groups of students, peasants and trade unionists opted out of the political and electoral system founding a number of guerrilla organizations. Army and paramilitary death squads embarked on a counter-insurgency, which in turn led to the expansion of the guerrilla movement and an increase in political violence. The violence reached a dramatic highpoint in March 1980 with the murder of the Archbishop of San Salvador, Oscar Romero, by a paramilitary squad. Although the guerilla movement, unified under the *Frente Farabundo Martí para la Liberación Nacional*, (FMLN), failed to spark a national rebellion, it effectively carried out a low-intensity guerilla war establishing strong areas of influence in the north and east of the country. In 1989 the new administration of President Alfredo Cristiani came

to office determined to bring an end to the conflict. Several key agreements in 1991 culminated in the Peace Accords signed in Mexico in 1992.

The Peace Accords brought an end to a conflict that had no winner and many losers. It is estimated that the civil war cost some 75,000 lives and displaced 1 million people (about 20 percent of the country's population). The war exacerbated migration to the US and destroyed infrastructure stock with a replacement cost of about 30 percent of the GDP. And at a time when the regional per capita GDP grew by 30 percent, the war generated a contraction in real per capita GDP in El Salvador of 25 percent over the period 1979–91 (the start and end dates of the conflict according to the Center for Defense Information). World Bank analysis concluded that, had armed conflict not taken place, the poverty rate in 2000 (44 percent) would have been lower by 15 percentage points, whereas child malnutrition and infant mortality would have been between $\frac{1}{4}$ and $\frac{1}{2}$ lower (World Bank 2003a). More than two decades after the end of the civil war political polarization remains high—as evidenced by a survey of parliamentarians' self-assessment showing that the Salvadoran parliament is the most ideologically polarized in Latin America.

The end of the conflict, together with an ambitious reform agenda, also brought the prospect for greater prosperity. Indeed, in addition to the end of the civil war and the consolidation of democracy, the first half of the 1990s witnessed the implementation of a coherent economic strategy leading to

the stabilization of the economy and the reactivation of growth. Structural reforms implemented at the time included trade liberalization, financial sector strengthening, re-privatization of the financial sector and other state enterprises, comprehensive tax reform, pension reform, and improvements in the competitiveness environment for private investment. Per capita GDP, which had declined by an average of about 3 percent per year over the 1980s grew by almost 4 percent per year over 1990–95, and poverty which in 1991 was above 60 percent was cut to less than 50 percent in 1995. Indeed, the World Bank's Country Economic Memorandum of 1995 argued that "*Stabilization and adjustment measures implemented since 1989 and the return to peace have laid the foundations for sustained growth in El Salvador.*"

However, by the late 1990s the economy slowed down noticeably and started to fall behind comparator countries in a process that has extended to the present day. Despite the reforms undertaken to modernize the country faster growth did not materialize after 1995. In fact, growth slowed down; the average growth rate over 1996–2001 was less than 1 percent. Within the Latin American context, the Salvadoran growth slowdown was also significant. Median Latin American growth also fell but the deceleration was not of a comparable magnitude. Since 2000, real annual per capita GDP growth has averaged 1.5 percent, well below the growth rates observed in lower middle income countries (2.5 percent) or in a set of peer countries that share similar structural characteristics as El Salvador (3.9 percent). Moreover, economic mobility is limited and the country's middle class has not grown as it has in much of Latin America over the last decade. This disappointing performance has contributed to a

continued flow of migrants out of the country in search for better opportunities and today about 2 million people of Salvadoran origin live in the U.S.

In terms of development, low growth stands out as the dominant feature. Out of 72 countries for which roughly comparable data on household income is available, only five countries had a lower growth of mean income than El Salvador since 2000. Not only has economic growth been low, but the trend since 2000 has been downward. In addition, the 2008 crisis hit the country hard given its heavy dependence on the US for remittances and exports; and recovery has been slow. In fact, in the period 2011–13 the economy grew at 1.9 percent annually, well below the LAC average (3.7 percent) and the middle income average (4.5 percent).

Although inequality has declined, slow growth has limited progress on poverty reduction. The income of the bottom 40 percent of the population has been increasing at a faster rate than the income of the overall population and income inequality, as measured by the Gini index, has declined (from 0.49 in 2004 to 0.44 in 2012). However, poverty reduction has been sluggish. This is hardly a surprise given the low growth rates and the empirical finding that growth is the driver of almost three-quarters of the changes in poverty in the country. In turn, this explains why poverty levels in 2012 are only slightly below those of 2000 (41 and 44 percent respectively) and why poverty reduction stands below its peers in Latin America and the Caribbean and among lower middle income countries. Labor income has driven poverty reduction, followed at a distance by remittances, but the contribution of labor income has been constrained by the low and declining economic growth.

El Salvador's predicament has been widely studied and our findings are largely consistent with the existing literature on the country's drivers of growth, inclusion, and sustainability.

Low investment and low productivity growth are the most cited causes of the growth performance of the country. The analysis in this report confirms the centrality of these two factors. Over the last two decades the growth slowdown can be mainly attributed to decreasing contributions of both capital and total factor productivity. At around 15 percent of GDP investment is among the lowest of in the world for its income group and total factor productivity growth over the past twenty years has been below 0.2 percent per year. But what is behind these factors? From a macroeconomic perspective, the most recent growth diagnostics analysis undertaken jointly by the El Salvador and the US governments concludes that there are two binding constraints to growth: security/crime and low productivity of the tradables sector. But many other factors have been put forward as additional explanations for the stagnation of the Salvadoran economy. Unfavorable terms of trade, natural disasters, and slow labor accumulation are also factors often discussed in the literature. Reflecting on the heavy reliance on remittances coupled with the high share of consumption in GDP has led some practitioners to label the Salvadoran economic development model as one of promoting the import of consumer goods and the export of labor.

Other studies have focused on the low returns to productive investment. Drivers of the low formal enterprise profitability include high wages for the given level of skills, the costs of protecting against crime, high costs

of services like electricity and transport, and insufficient learning of better technologies and business practices. Given these competitiveness pressures the tradable sector has been stagnant. The fastest growing sector has been services, whose productivity has been decreasing, constraining the growth of workers' earnings and hence inclusion. At the level of the enterprises, a high degree of concentration in industry and limited entry for the production of non-traded goods especially is also having a negative impact on the adoption of new technologies, hampering within-firm-productivity growth. The ability of the government to foster competition is weak and the perception of corruption is high. Uncertainty about the appropriation of gains is arguably another factor that drives the low investment. This uncertainty stems in part from mistrust in the political arena.

More recently studies have stressed the negative impact of crime and violence. The economic cost of this violence is very high, 11 percent of GDP annually including material losses, public and private security and health costs. An analysis of constraints using the growth diagnostics methodology was undertaken by the US and Salvadoran Governments as part of their Partnership for Growth (USG-GoES 2011). This updated growth diagnostics concludes that lack of security is one of binding constraints to growth together with low productivity of the tradables sector.

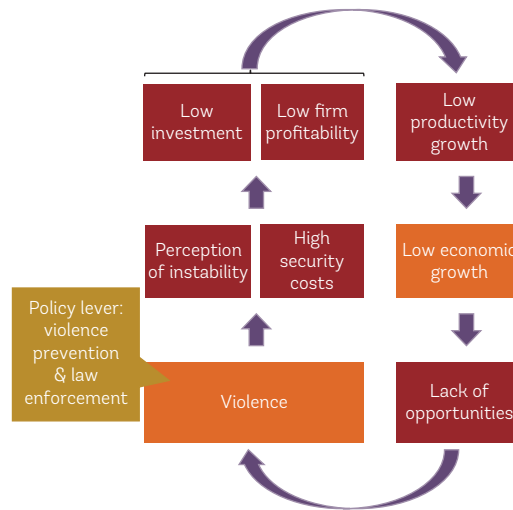
Underlying these challenges is a political sphere plagued by mistrust and highly polarized, acting as a bottleneck to structural change. El Salvador has at times been slow to respond to rising challenges with the consequence that they escalate into major constraints over time. The pervasive political

mistrust—a legacy of the recent political history—partly explains the delayed or lingering responses. For example, the policy response after the 2008 global crisis rightly focused on fiscal reform and consolidation with some success in mobilizing resources but limited gains in reigning in untargeted subsidies. The fiscal challenge remains today. The political polarization and mistrust appear to prevent agreement across the board on critical national priorities. The country for example has been slow to respond to the threats to its industry and exports from Asian competitors. The rising threat from crime and violence, while widely acknowledged as extremely damaging across the board, has not coalesce countervailing forces to keep the threat at bay.

These elements described above are also identified in this report as important bottlenecks. This report, however, goes a step beyond and argues that escaping from the apparent low growth equilibrium will be complex because the identified bottlenecks reinforce each other. In particular, this SCD identifies three inter-connected vicious circles that hamper growth and shared prosperity: (a) the cycle of low growth and violence; (b) the cycle of low growth and migration; and (c) the cycle of low growth, savings and investment.

First, there is a vicious circle between low economic growth and violence (see figure O.1). Low growth limits the income and the opportunities of the population, therefore creating incentives for some individuals to join a gang or *narco* group which may offer significant short term earning opportunities (particularly in countries where impunity levels are high and the gangs have a strong and widespread presence in the country). In turn, high levels of violence (El Salvador is

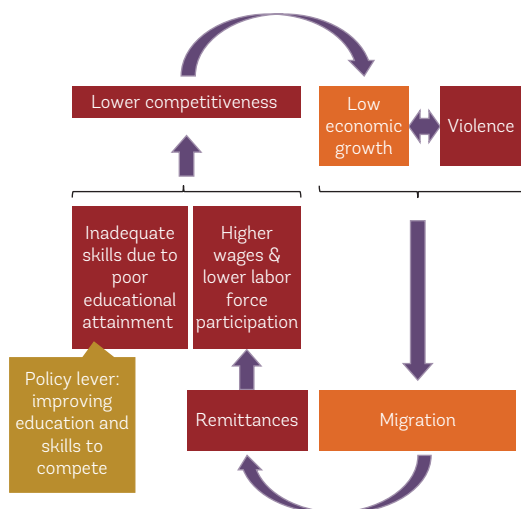
FIGURE O.1 Vicious Circle of Low Growth and High Violence



one of the three Central American countries where the homicide rate is at the top of global rankings) have a significant negative impact on the investment climate (security costs in El Salvador represent about 3.5 percent of firms annual sales, and these is increasing evidence that crime and extortions are prompting firms to exit the market place altogether). The higher risks and costs of insecurity deter investment and reduce firm profitability, resulting in lower productivity growth—which in turn hampers overall economic growth in a self-reinforcing negative cycle.

The second is the vicious circle between low growth and high remittances (see figure O.2). The interaction of low growth and violence pushes many Salvadorans to migrate in search of better opportunities, often following relatives who previously migrated for similar reasons. Two million Salvadorans already live in the U.S. and provide a strong pull factor for further migration. A large real wage gap keeps attracting migrants to the U.S., with Salvadoran migrant families in the

FIGURE O.2 Vicious Circle of Low Growth and High Migration

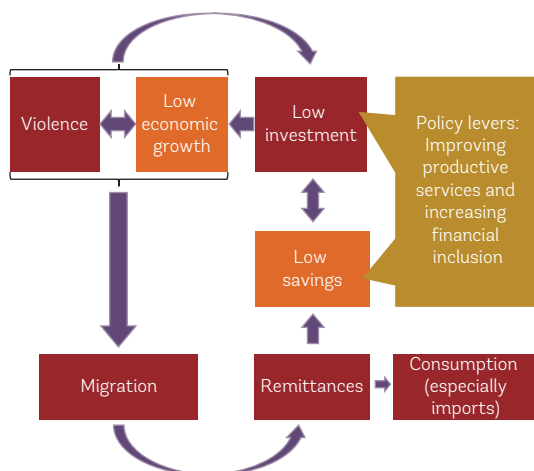


U.S. averaging about five times more in per capita income than their counterparts back home. Violence is another “push” factor for migration, with a strong correlation between victimization and intentions to migrate. The migration flows from El Salvador to the U.S. have been accompanied by large remittance flows, amounting to 16 percent of GDP in 2012. These remittances have in all likelihood contributed to a better standard of living in the country, and macroeconomic stability. But the outcome of migration remittances also results in complex dynamics. Increases in capital inflows associated with migrant remittances lead to an increase in consumer demand. In turn, as households see their incomes rise, reservation wages increase and labor supply falls. Remittances sent by Salvadoran migrants have been found to reduce both the labor participation rates (by about 10 percentage points) and the number of hours worked (between 5 and 12 hours per week) by those at the receiving end due to the income effect generated by

remittances. And remittances have also been found to lead to real exchange rate appreciation. These effects would have contributed to lower the competitiveness of the economy, limiting the ability of Salvadoran firms to compete in low value added tradable sectors. At the same time low education outcomes (a constant in Central American countries) also prevent the country from moving fast to high value added tradable sectors relying on the skills of the labor force to offset the above-described Dutch disease forces. Higher wages and lower skills and labor force participation, plus real exchange rate appreciation associated with higher capital inflows from remittances, combine to reduce El Salvador’s competitiveness—and ultimately, growth.

A third vicious circle involves the self-reinforcing dynamics of low growth, savings and investment (see Figure O.3). Remittances have the potential to smooth consumption. And yet, there is little evidence that remittances in the country have been used as insurance. Indeed, there is evidence indicating that in El Salvador the propensity to save out of the remittances income is lower than the corresponding savings rate from non-remittance income (2 to 4 percentage points depending on whether the comparison is done controlling for household characteristics). This contributes to a lower aggregate saving rate in a country that already stands out as having a particularly low savings ratio (11 percent of GDP), and to a lower aggregate investment rate, and ultimately lower economic growth. Although service providers are widely used to channel remittances, regular use of accounts in financial institutions by households and MSMEs is much more limited. Only 6 percent of the bottom 40 percent have an account with

FIGURE 0.3 Vicious Circle of Low Growth and Low Savings and Investment



formal financial institutions. Lack of financial access limits the capacity of the financial sector to intermediate between savers and investors. Low savings contribute to low aggregate investment, which is also constrained by high energy and logistics costs. In turn, low investment hampers economic growth.

Thus, the reasons behind the low growth are reinforced by the low growth itself once the effects of migration and remittances are taken into account. While admittedly it is difficult to quantitatively assess the weight of each of these forces, it is nevertheless critical to take them into account for prioritization purposes.

Building on strengths

On a more positive note, El Salvador possesses a number of opportunities that could provide a basis to propel the country to a higher growth path. El Salvador has not made an effective use of its opportunities. The current forecast is for the country to grow at

around 2 percent over the medium term. The authorities envisage a higher growth path, anchored on reforms to make a fuller use of the opportunities available. Areas of opportunity include migration, geographic and cultural proximity to large export markets, and a still relatively large manufacturing base.

First, make more of the opportunities that migration affords. Missing in El Salvador, at least in part, are some of the ingredients associated with the positive impact of a diaspora on development. These include migrants returning to retire at home and prepare to do so by investing, skilled migrants returning home bringing back skills (including entrepreneurship), the diaspora providing a network for selling goods abroad, the diaspora strengthening the demand for governance, and remittances encouraging increased financial literacy and savings.

Second, a strategic location that places the country well as an investment destination. El Salvador is strategically located close to the U.S. and has the basic infrastructure in place, in some cases highly competitive like in air transportation. In addition to the geographic location and connectivity, the country is connected through its diaspora abroad, which has a direct experience of the foreign markets and serves as a valuable entry point. This knowledge and understanding of selected markets and cultures abroad is a potentially solid point of comparative advantage, vis-à-vis potential competitors.

Third, an industrial base that can support an expansion of the tradable sector. At 20 percent of GDP the manufacturing sector is large by LAC and by middle-income country standards. Although *maquila* stills plays an important role, there are segments of the industry with skills in applying sophisticated technologies and connecting with the global

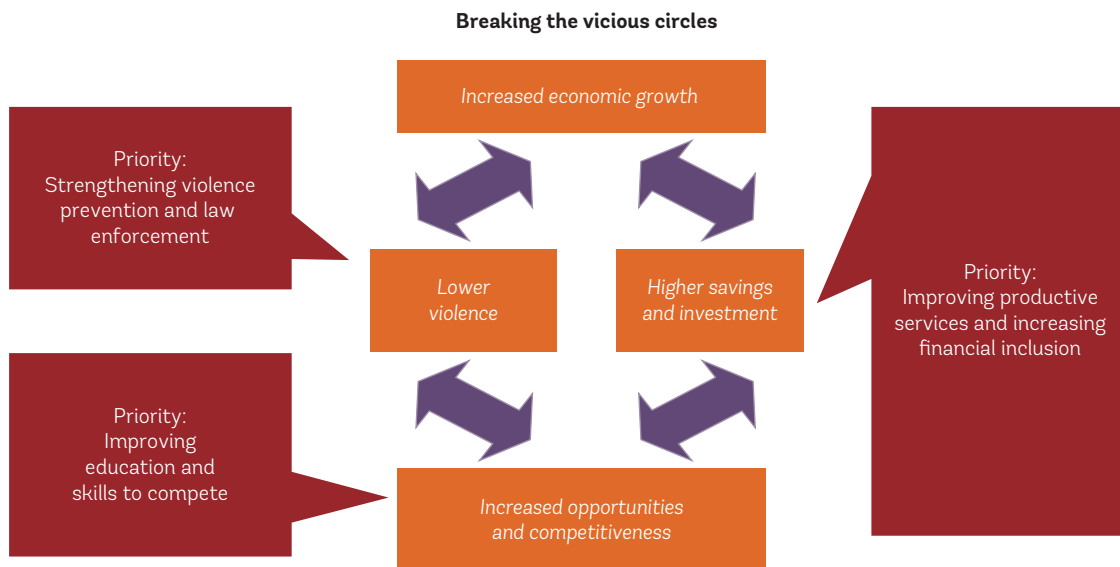
economy. These advanced activities have emerged and survived despite the adverse conditions. Around them networks of suppliers and skills development have developed that provide effective examples that under the right conditions can be scaled up or replicated in other activities.

Priorities—the need for a “big push”

Breaking the vicious circles identified will require a “big push.” Marginal interventions are unlikely to help break the self-reinforcing dynamics that have kept El Salvador trapped in a vicious circle that links low economic

growth, high migration, and high violence. Given the numerous challenges faced by the country a mechanical approach to identify priorities would miss important nuances and result in a simplistic list of priorities. In practice, the approach followed to identify priorities took into account three key considerations. First, given the existence of self-reinforcing dynamics, entry points that could help break those vicious circles were identified as priorities. Second, areas where improvement may be a *sine qua non* condition for progress were also identified as priorities. Third, consideration was given to issues that would complement progress in different areas.

FIGURE 0.4 Priorities



Sustainable improvements also require prioritizing:

- Strengthening of the fiscal position to safeguard fiscal sustainability
- Forging political consensus to build a more transparent and effective state
- Improving the resilience of the country to natural disasters

Priority areas to break the vicious circles include:

- (i) Strengthening violence prevention and law enforcement;
- (ii) Improving education and skills to compete; and,
- (iii) Improving productive services and increasing financial inclusion.

The importance of strengthening violence prevention and law enforcement derives from the high social and economic costs imposed by crime and violence. The homicide rates in El Salvador since 2000 have been among the top 5 countries in the world; at 30 per 100,000 the homicide rate is five times the world average and had reached a peak of 60 homicides per 100,000 before a truce between gangs (*maras*) was agreed to in March 2012. The widespread availability of small firearms facilitated the expansion of violence. The *maras*, created among the Salvadoran migrant communities in the US, have further fueled violence as their members returned to El Salvador (either voluntarily or deported) and introduced to the country a criminal enterprise that lured the youth by providing a sense of identity. Today the *maras* count their members in the tens of thousands. This environment has been welcoming to drug trafficking. In addition to paying for private security costs, which are among the highest in the world, there is increasing evidence that fear of crime, and in particular extortions, prompts some businesses to exit from the marketplace altogether.

Improving education and skills would positively impact growth, inclusion, and sustainability. Higher learning outcomes, even at the current levels of attendance, would better equip the youth for the acquisition of skills necessary in the domestic market or in the markets where people migrate. A more

educated and skilled population in the domestic market would alleviate the relatively high costs of labor. For migrants, it will represent better opportunities abroad, and possibly higher remittances into the country. Moreover, the country may follow an active policy of training migrants focused on skills that facilitate entry into selected labor markets abroad. It is also likely that improved educational outcomes contribute to the higher retention rates at the secondary level. Education is a key building block for other priorities, in particular reducing crime and violence.

Improving productive services would help improve competitiveness, which is currently negatively impacted by expensive productive services, including electricity and logistics. The supply mix of electricity has been shifting to non-renewable sources, thus increasing costs. The energy sector is highly privatized but there are concerns about how to induce the entry of the private sector into competitive activities—gas, solar, etc. In addition, in view of the high cost of generation and the dominance of thermal power, energy efficiency would bring important cost, environmental, and fiscal benefits. In road transportation, the constraint is not so much the physical infrastructure but high costs arising from a concentration in the provision of services. The prospects today are for further increases in the prices for productive services.

Increasing financial inclusion could help increase the development impact of remittances by raising savings and investments. The financial sector is sound but financial inclusion is low; the bulk of the remittances are transferred outside the banking sector. This results in an incentive to consume given the limited rates of saving and investment. The low level of savings means that the economy

can accommodate only a low level of investment as FDI inflows are relatively small.

But sustainable progress will also require prioritizing:

- Strengthening of the fiscal position to safeguard fiscal sustainability
- Forging political consensus to build a more transparent and effective state
- Improving the resilience of the country to natural disasters

Strengthening the fiscal position is a prerequisite for further progress. Fiscal deficits and slower economic growth since the global crisis have increased public debt. Public debt relative to GDP went from 40 percent in 2008 to 58 percent in 2013. There are no immediate concerns about debt sustainability, but continuing the growth and fiscal trends of the recent past would increase the debt to GDP ratio up to 70 percent in 2019. So stabilizing debt levels will require fiscal adjustment between 1.5 percent and 3.5 percent of GDP depending of the target level for the public debt. The most significant fiscal issue now are the management of the pension debt issued as the country transitioned from a defined contribution system and improving the targeting of subsidies in electricity, gas, water and transport. The current environment of low oil prices may provide an opportunity to address subsidy reform. A higher rate of economic growth would alleviate the fiscal difficulties, finance priority expenditures and investments, and boost the income of the bottom 40. At the same time, there is scope for mobilizing additional tax revenues—which at around 15 percent of GDP remain comparatively low.

Forging political consensus to build a more transparent and effective state will help across a number of areas. A weak state has been unable to contain and reduce the

impact of crime and violence. Impunity prevails as the criminal conviction rate is less than 5 percent. Police and judiciary are widely perceived as corrupt and the Supreme Court has the lowest level of citizen confidence among major public institutions. Private security expanded to fill the vacuum; Enterprise Surveys suggest that firms spend 3.4 percent of sales in protection, amongst the highest percentages in the world. The quality of public institutions has remained stagnant, which has not helped to build trust among the citizenry. In addition, the difficulty of the state in providing security has exacerbated a lack of trust by the citizens in public institutions. The weakness of the state shows also in its limited capacity to mobilize internal revenues and spend them effectively.

Finally, improving the resilience of the country to natural disasters will help ensure the sustainability of progress in the above areas. El Salvador is also one of the countries in the world that is most affected by weather-related events and other natural hazards. Combined, El Salvador incurs annual losses of around 2.5 percent of GDP due to natural disasters. These losses add to fiscal pressures and constrain wealth accumulation. Climate change is expected to increase the frequency and severity of the weather-related events.

Process

Consultations with stakeholders helped to inform this SCD. This SCD has drawn on existing material, new analyses commissioned for this SCD (such as a Computable General Equilibrium model), and, crucially, on a set of consultations with a broad range of experts and stakeholders in El Salvador. Throughout the consultations there was a broad consensus on the diagnosis of the challenges faced

by El Salvador. Above all, there was a wide recognition of the importance that migration plays in the country. In addition, the themes of political polarization, violence, and institutional quality and capacity were also broadly identified as the ultimate causes for the stagnation that has affected El Salvador. Consultations proved also very useful in identifying some of the opportunities and strengths on which the country can build on, such as an already diverse manufacturing sector. The fact that this SCD was being prepared simultaneously as the Government's Five-Year Development Plan provided ample opportunities for cross-fertilization.

Knowledge gaps

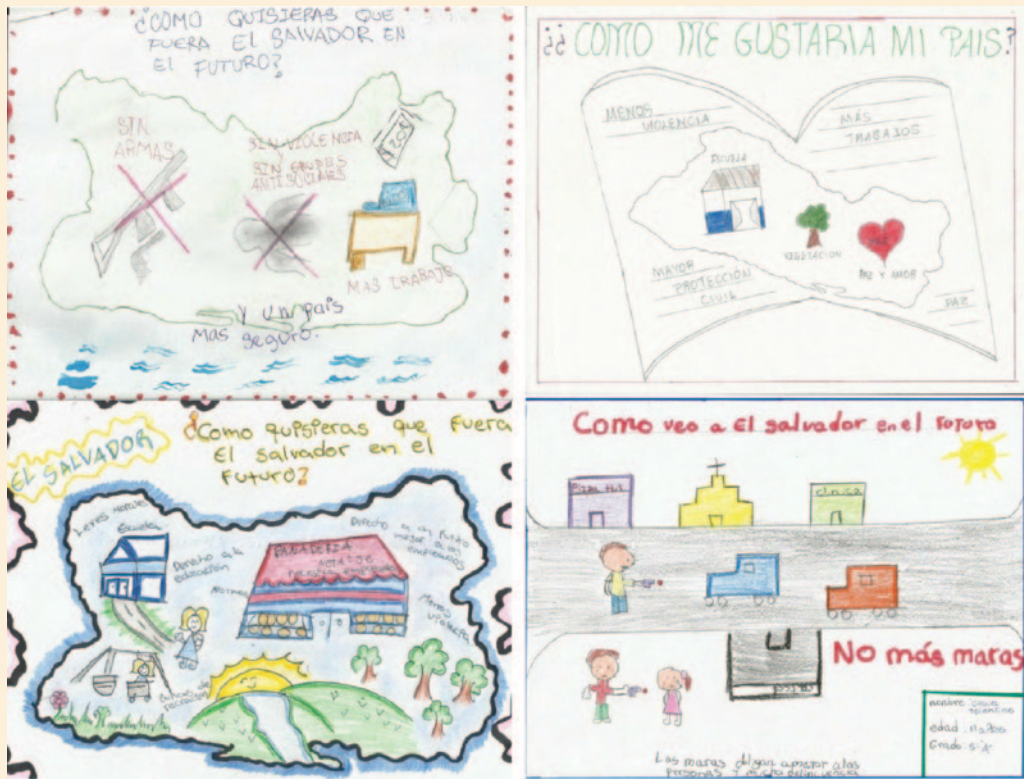
Although there are many analyses of the nature and causes of El Salvador's stagnation this SCD identifies some knowledge gaps in the existing analyses. In identifying knowledge gaps the SCD focused on areas where new information could help inform specific actions in the priority areas. A number of concrete knowledge gaps were identified: (a) What is the impact of frequent natural disasters on the more vulnerable? (b) How do we explain the paradox of a widespread perception of corruption with low bribe payments? (c) To what extent is high crime the

result of limited opportunities and how does it affect shared prosperity? (d) How does limited domestic competition affect shared prosperity? (e) Why is the rate of female labor force participation low? and, (f) Why so many students drop out of school?

This SCD is structured as follows: A first chapter sets the stage by reviewing trends in poverty reduction and shared prosperity and providing a first approximation at the drivers of these trends. This introductory chapter also presents some key country features. The following three chapters provide analyses of the main factors affecting growth, inclusion, and sustainability. These three chapters describe in greater detail the nature of the challenges, dig deeper into exploring the causes behind, and identify policy areas that could be critical for boosting growth and inclusion and ensuring sustainability. The fifth and final chapter provides three related but distinct contributions. First, it provides a synthesis of the analysis under the three previous chapters. Second, it provides a discussion of potential entry points for policy action, reflecting also on what are some the existing strengths in the country. And, third, it concludes with a discussion of the priorities to boost shared prosperity, including a discussion of why they were identified as priorities as well as a discussion of potential actions.

BOX 0.1 How Would You Want El Salvador To Be in the Future?

Throughout the preparation of this SCD the team often wondered about the hopes and aspirations of the new generation of Salvadorans. This helped us to keep in mind the forward-looking nature of this work. In this spirit, the World Bank's Country Office asked fifth grade students in schools across El Salvador to picture how they would like their country to be in the future. One of the most common themes in the drawings was the wish for a future without violence.



1. Setting the Stage

Trends in Poverty Reduction and Shared Prosperity

EL SALVADOR HAS HAD LIMITED POVERTY REDUCTION in recent years. El Salvador is a lower middle income country with a rate of extreme poverty in 2012 of around 2.5 percent using the international poverty line of \$1.25/day (or around 15 percent using \$2.5/day). Using the national poverty lines the rates of extreme and overall poverty stood in 2012 at 11 and 41 respectively. The rate of overall poverty has been persistently high since 2000, when it stood at 45 percent (see figures 1.1 and 1.2). Moreover, the food, fuel, and global economic crises of 2008–09 increased poverty temporarily. The reduction has been more pronounced for extreme poverty, which stood at 19 percent in 2000. This has been thanks to a steeper poverty reduction in rural areas, where extreme poverty was concentrated and where the effects of the global economic crisis were not felt as strongly as in urban areas.

Poverty reduction has been less pronounced than in other countries, especially since 2008. The small decrease in the overall poverty rate in El Salvador stands out when compared with the experience of other countries in Latin America and the Caribbean where, on average, poverty has continued to decline at a significantly faster pace (see figure 1.3). The poverty reduction experienced by El Salvador since 2000 has also been much lower than the country had achieved in the 1990s, when overall poverty

declined by more than a third.¹ Estimates of socio-economic mobility based on synthetic panels show that only 5 percent of households moved out of poverty between 2004 and 2007 and stayed out of poverty by 2012.

There are substantial differences between the poor and non-poor in terms of their human capital, employment status, and household characteristics. A profile of the poor according to the national poverty line is presented in table 1.1 below. It is worth noting that given the poverty rate (41 percent according to the national definition) this profile corresponds roughly with that of the bottom 40. The average income of the

FIGURE 1.1 Poverty Reduction Has Been Sluggish

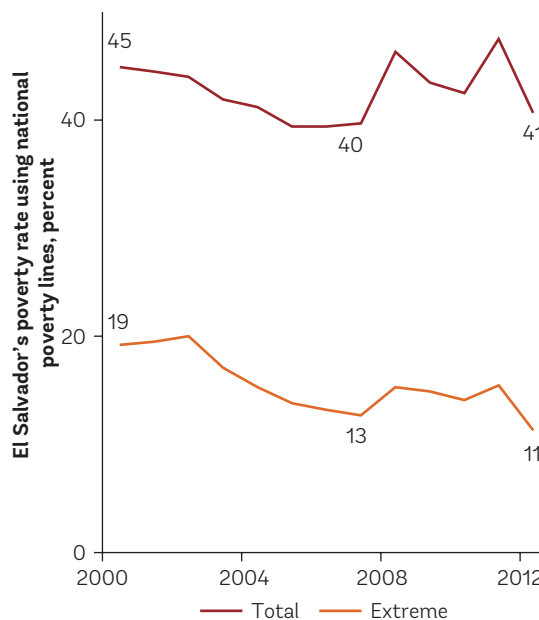
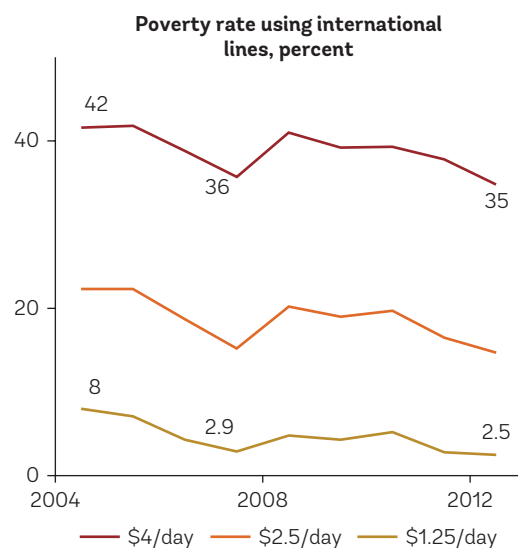


FIGURE 1.2 Extreme Poverty (at \$1.25/day) Is Below Three Percent of the Population



Source: World Bank staff based on Encuesta de Hogares de Propósitos Múltiples (EHPM).

non-poor is close to four times that of the poor. On average, a person living in poverty has three years less schooling than a non-poor person. The household composition is also noticeably different, with the share of children under 12 years old being around 12 percentage points higher among poor households than non-poor households. The poor are ten percentage points more likely to be self-employed and twice as likely to be an unpaid family worker as the non-poor. Women living in poverty are less likely to be economically active than their non-poor counterparts, showing a 20 percentage points gap in labor force participation, but there is no evidence that female headed households are more likely to be poor. While, as noted in figure 1.4 above, poverty rates in urban areas are lower than in rural areas, the number of urban poor is slightly

TABLE 1.1 Profile of the Poor (2012, National Definition)

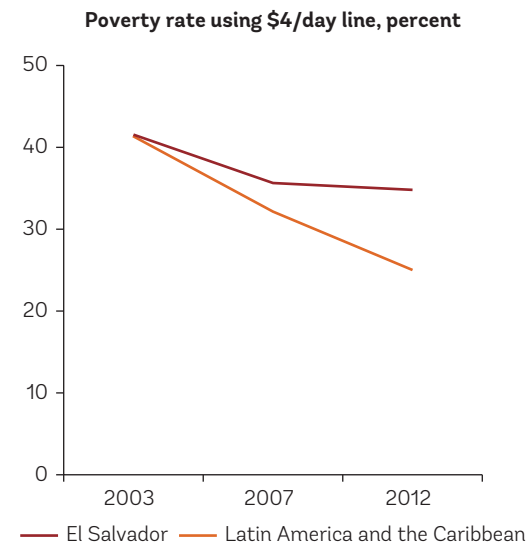
	Non-poor	Poor		Non-poor	Poor
<i>Household characteristics</i>			<i>Labor force (%)</i>		
Age of head	49.2	47.6	Employee	63.8	46.2
Female-headed, percent	35.9	33.8	Employer	4.6	1.8
Per capita daily income ^a	11.3	3.1	Self-employed	23.4	34.4
Yrs. of education of head	7.5	4.3	Unpaid worker	6.6	13.1
Household size	3.4	4.5	Women active (aged 25–65)	57.8	37.8
Live in urban area (%)	70.4	57.1	Men active (aged 25–65)	82.3	82.8
Proportion age 0–12 (%)	15.5	27.2	<i>Employment sector (%)</i>		
Proportion age 13–18 (%)	10.6	14.2	Construction	5.1	5.4
Proportion age 19–70 (%)	65.8	51.9	Domestic services	4.4	4.6
Proportion age 70+ (%)	8.2	6.7	Manufacturing	16.3	14.2
<i>Employer (%)</i>			Primary sector	12.7	37.0
Private employee	88.7	98.1	Retail	30.2	23.6
o/w Private small	41.3	24.1	Services	25.3	12.3
Private large	58.7	75.9	Utilities	5.9	3.0
Public employee	11.3	1.9			

Source: World Bank staff calculations with data from EHPM 2012 (DIGESTYC 2013).

Note: Large firms are defined here as more than 5 workers and small firms as less than 5. Given that the poverty rate as per the national definition is 41 percent this profile mirrors that of the bottom 40 of the population.

a. In 2005 US dollars.

FIGURE 1.3 Lower Poverty Reduction than in Other Countries, Especially Since 2008

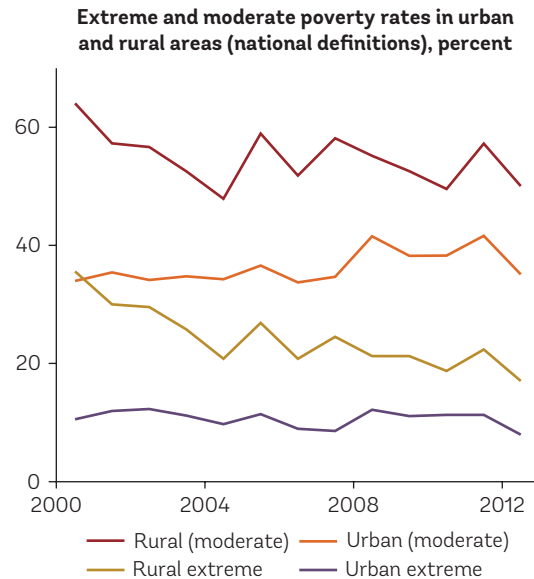


Source: World Bank staff calculations using EHPM.

higher than the number of rural poor (57 percent of the poor live in urban areas). Finally, the poor are much more likely than the non-poor to work in the primary sector.

There are also differences in the prevalence of poverty across the territory. While there is already a higher number of poor living in urban areas (as shown in table 1.1 above), spatial disparities in the rate of poverty remain large. In fact, poverty rates in some of the poorer departments are almost 30 percentage points higher than in the San Salvador department. The five departments with the largest centers (San Salvador, San Miguel, Santa Ana, La Libertad, and Sonsonate) are also the five departments with the lowest poverty rates (see figure 1.5). Access to services and connectivity differs also across the territory

FIGURE 1.4 Extreme Poverty in Rural Areas Has Fallen the Most



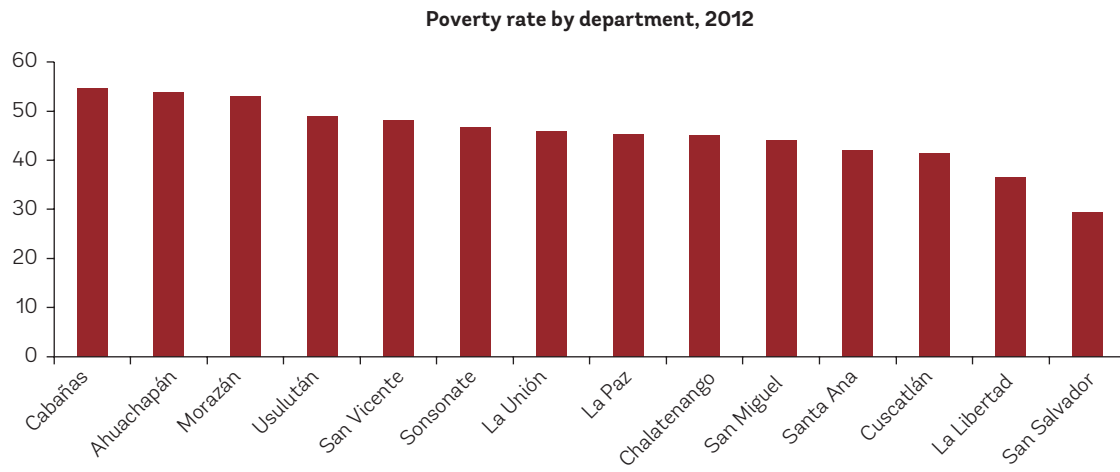
Source: World Bank staff calculations using EHPM.

(Amaya and Cabrera 2012). At the same time, the poor concentrates in the five departments with large urban centers, as they hold around 57 percent of the poor nationwide (see further below and, for a broader country context, see box 1.1).

Shared prosperity

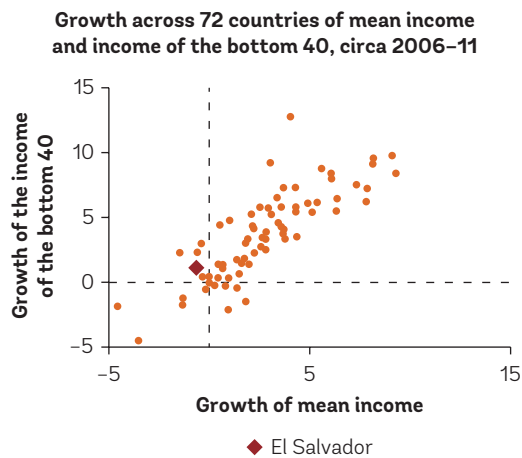
The growth of the income of the bottom 40 percent has been low compared to other countries. El Salvador is one of the few countries in the world where the growth of mean income has been negative but there has been some growth of the income for the bottom 40 percent (see figure 1.6). Real mean per capita income decreased by 0.6 percent p.a. from 2006 to 2011, while the real per capita income of the bottom 40 increased by 1.1 percent p.a. However, the growth of the bottom 40 in El Salvador lagged that of many

FIGURE 1.5 Poverty Disparity Remains Large across the Territory



Source: World Bank staff based on EHPM.

FIGURE 1.6 Lagging Behind on Shared Prosperity



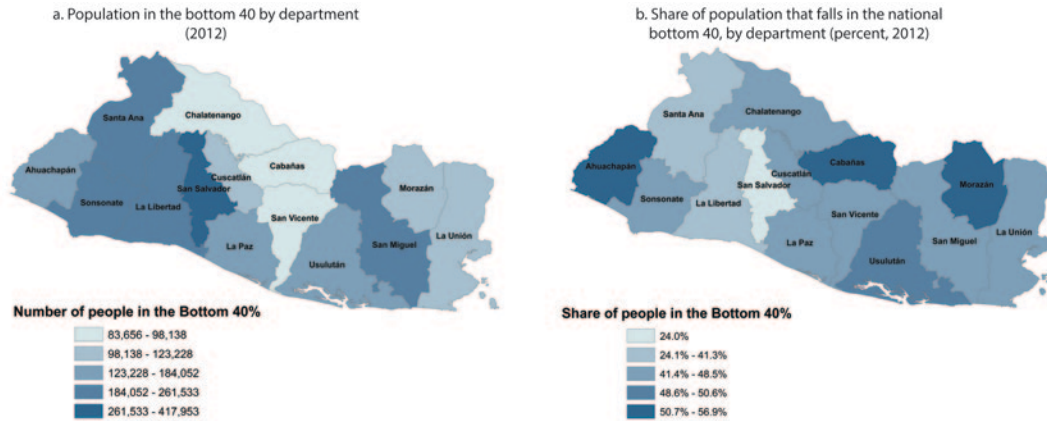
Source: World Bank.
 Note: Based on real mean per capita consumption or income measured at 2005 Purchasing Power Parity (PPP).

other countries. Out of 72 countries for which roughly comparable data is available, there were 54 countries that had higher income growth of the bottom 40 percent than El Salvador. And only five out of the 72 countries worldwide had a lower growth of mean

income than El Salvador.² This Salvadoran pattern of higher (but still low) growth of the bottom 40 emerged as a result of a particularly high growth in the very bottom of the income distribution (see discussion under the chapter on inclusion below) which also helped reduce extreme poverty as shown above.³

The bottom 40 is more concentrated in largely urban departments but rural departments have a higher share of the population that falls in the national bottom 40. Around 57 percent of all the people in the bottom 40 of the national income distribution live in the five departments with the largest cities (San Salvador, San Miguel, Santa Ana, La Libertad, and Sonsonate). Still, as shown in map 1.1 below the mostly rural departments of Ahuachapán, Cabañas, Morazán, San Vicente, and Usulután have the highest share of the population with incomes in the national bottom 40 percent. While in the department of San Salvador only 26 percent of the population fall in the national bottom

MAP 1.1 The Bottom 40 Are Concentrated in Large Urban Areas but Rural Areas Have a Higher Share of Population among the Bottom 40



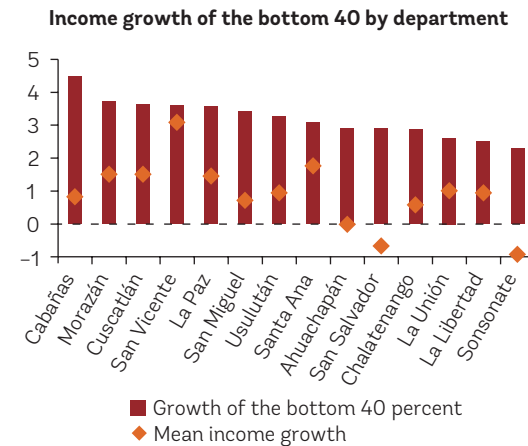
Source: World Bank staff calculations based on EHPM.

40 percent, the corresponding figure for Cabañas, Morazán is 56 percent.

The income of the bottom 40 is growing faster than mean income in all departments—although there are still large differences in human development across the territory. The two departments with the highest share of their population in the bottom 40, Cabañas and Morazán, exhibit the highest growth of incomes of the bottom 40 (see figure 1.7). Still, despite this equalizing growth of incomes, those two departments have the lowest levels of development (see map 1.2).

But the middle class has not increased. El Salvador has not experienced the increase in the middle class that has recently characterized much of Latin America (see figure 1.8). Economic mobility has been limited, even though inequality declined steadily (as discussed later). Consultations for this Systematic Country Diagnostic (SCD) revealed a broad consensus that a stagnant middle class was a critical issue as it limits the opportunities for social advancement and perpetuates the

FIGURE 1.7 The Income of the Bottom 40 Has Grown Faster than the Average in All Areas



Source: World Bank staff based on EHPM.

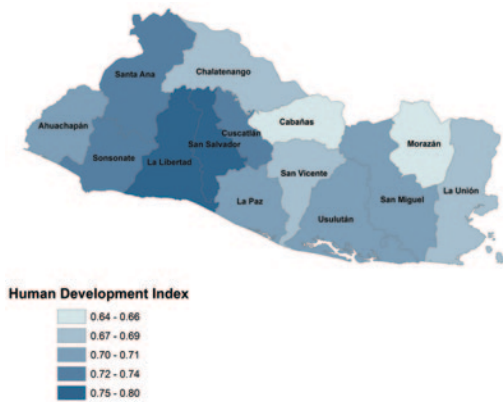
view that opportunities are to be sought by migrating.

And many people in urban areas live in slums. As population continues to increase in urban areas, slums (known as *asentamientos*

urbanos precarios) have grown. There are around 2,500 slums in the country housing almost half a million households (FLACSO, MINED, and PNUD 2010). Those living in slums are the most vulnerable to be affected by disasters and crime. In some cases house-

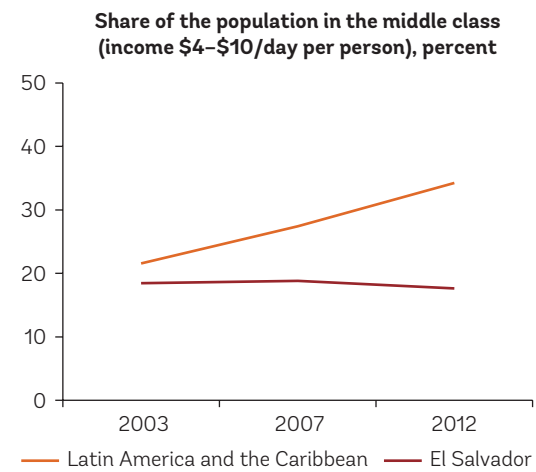
holds with incomes above the bottom 40 are still living in slums and suffering precarious living conditions. For example, the number of households living in slums in San Salvador is 30,000 larger than the number of households in the bottom 40 (see figure 1.9).

MAP 1.2 But There Are Still Large Differences in Human Development across Departments



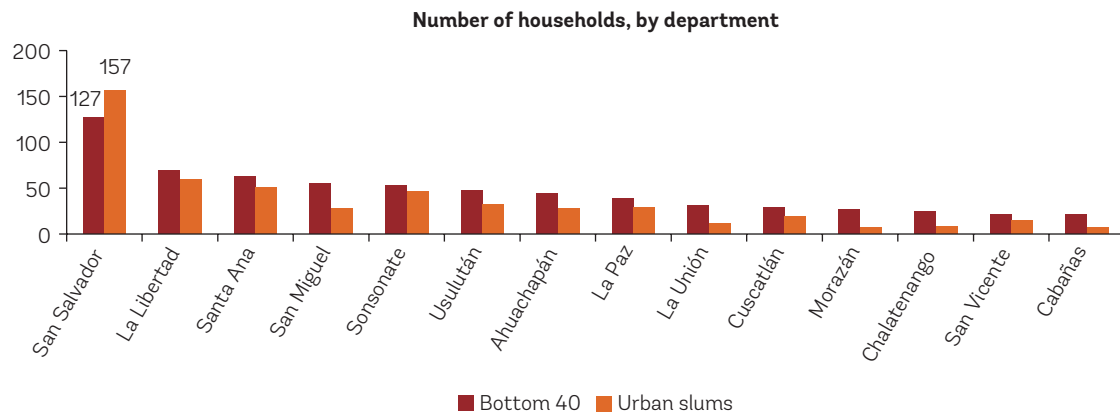
Source: UNDP.

FIGURE 1.8 Middle Class Stagnant



Source: Ferreira et al. 2013.

FIGURE 1.9 Many Live in Urban Slums, Even Households that Are Not in the Bottom 40



Source: FLACSO, MINED, and PNUD (2010) and World Bank staff calculations based on EHPM.

BOX 1.1 Country Context

El Salvador is a small middle-income country with a large diaspora. With a population of 6.3 million and a gross domestic product (GDP) of \$23.8 billion in 2012, El Salvador's per capita GDP stands at around \$3,800 in nominal terms. El Salvador is the smallest and most densely populated country in Central America. Population density is ten times the average for the Latin America and the Caribbean region. Almost two-thirds of the people live in urban areas and less than 1 percent is considered to be indigenous.

Around 2 million people of Salvadoran origin live in the U.S. and remittances accounted to around \$3.9 billion in 2012 (over 16 percent of GDP). El Salvador is exposed to numerous natural hazards, including tropical storms, earthquakes, and volcanic eruptions. With a homicide rate of around 41 deaths per 100,000 people El Salvador's is one of the highest in the world. Besides a high level of homicides the country also suffers from high levels of extortion and other crimes related to street gangs, so-called *maras*. The services sector accounts for more than 60 percent of GDP and the economy has been officially dollarized since 2001.

Since the end of the twelve-year civil war in 1991, El Salvador has made progress in consolidating peace and democracy, but politics remains polarized. The national political stage is dominated by two main political parties—the National Republic Alliance (ARENA) and the Farabundo Martí National Liberation Front (FMLN). ARENA held the executive branch of the Government from 1991 until March 2009, when the FMLN candidate, Mauricio Funes, won the presidential election. While the smooth handover of political power marked an important landmark in the country's political history the political environment remained highly polarized.

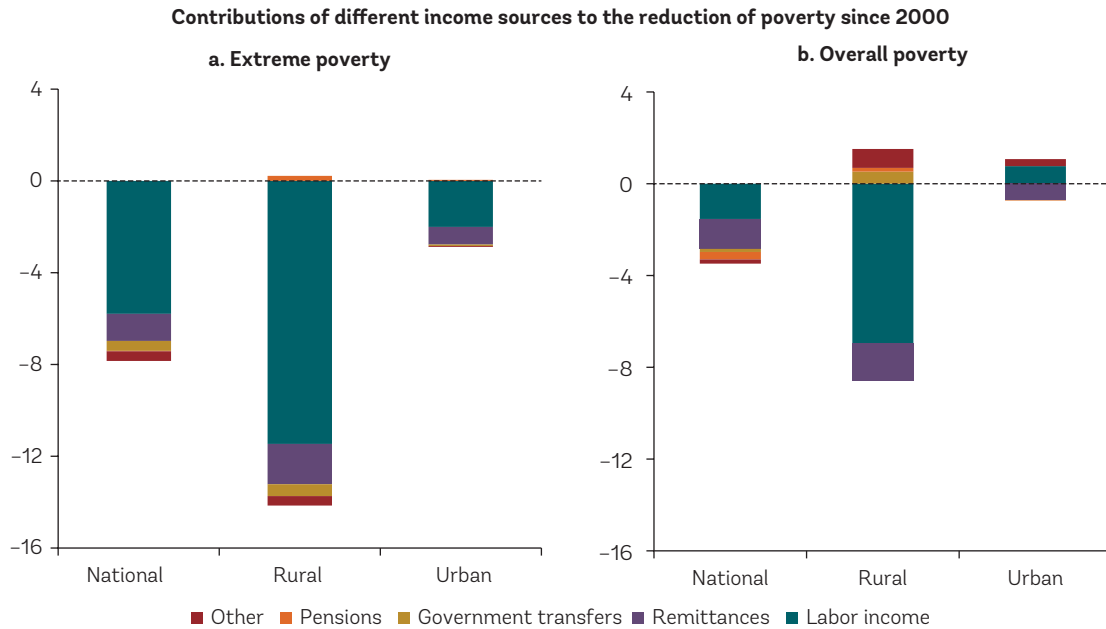
The FMLN narrowly won the presidential election held in March 2014 and President Salvador Sánchez Cerén assumed office on June 1, 2014. The twin goals of ending extreme poverty and boosting shared prosperity are fully aligned with the objectives of the new administration which released its Five-Year Development Plan in January 2015. The 2014–19 Development Plan lays out the high-level objectives of a country that is more productive, educated, and safe (*El Salvador: Productivo, Educado y Seguro*).

Drivers of Poverty and Shared Prosperity

LABOR INCOME AND REMITTANCES have played the largest role in contributing to poverty reduction. An analysis of the

contribution of different income sources to the reduction of poverty since 2000 shows the importance of labor income as a source for poverty reduction (see figure 1.10 below), especially for getting people out of extreme poverty and for lifting rural

FIGURE 1.10 The Labor Market Played A Key Role in Getting People Out of Poverty



Source: World Bank staff calculations based on EHPM.

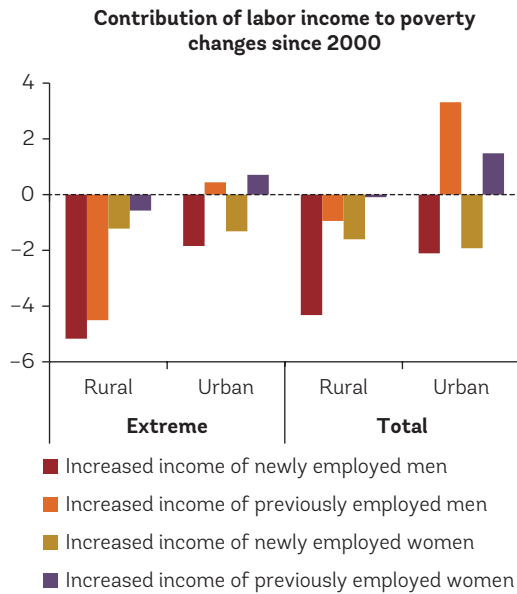
households out of poverty. However, for urban households remittances have played a more significant role. The role of remittances, which often result from a conscious intra-household decision to migrate and take advantage of foreign labor markets as a source of income, merits further attention and will be discussed further below.

Unpacking the contribution of labor income shows significant differences between urban and rural areas. In rural areas the positive contribution of labor income to poverty reduction resulted mainly from increases in income of men, while in urban areas both men and women exhibited a similar pattern. In urban areas the only positive contributor to poverty reduction resulted from the labor income of newly employed men and women, but not from

the labor income of previously employed men and women. In rural areas both factors, income from newly and previously employed workers, contributed to a reduction of poverty (see figure 1.11).

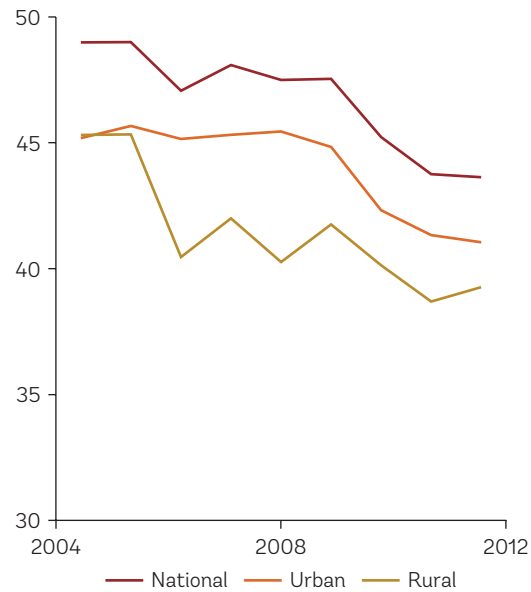
Government transfers have played only a limited role in reducing extreme poverty, and only in rural areas. As shown in figure 1.10 above the role of government transfers has been limited in reducing poverty. The highest contribution of government transfers has been to reduce extreme poverty in rural areas, but even in that case the contribution has been limited compared to other sources of income: 82 percent of the reduction of extreme poverty in rural areas can be explained by labor income, while remittances explain 13 percent, and government transfers only 4 percent.

FIGURE 1.11 Different Patterns in the Role that Labor Income Played in Rural and Urban Areas



Source: World Bank staff based on EHPM.

FIGURE 1.12 Gini Coefficient among Urban, Rural, and National Households



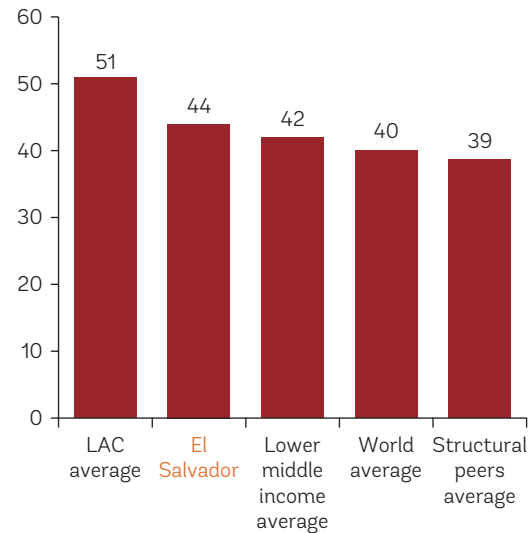
Source: World Bank staff based on EHPM.

What was the contribution of inequality?

Inequality has declined, contributing positively to shared prosperity. The Gini coefficient for income decreased from 0.49 in 2004 to 0.44 in 2012, a decline that was slightly higher than that observed for Latin America as a whole. Despite this decline, inequality remains higher than the average for lower middle income countries and other comparator countries (see box 1.2), although not when compared to the rest of Latin America. In El Salvador the cumulative income of the bottom 40 percent is around 16 percent of total national income, higher than the average for Latin America and the Caribbean, which stands at 11 percent.

The finding of a decline in the Gini coefficient is robust to accounting for the different

FIGURE 1.13 Gini Coefficient in El Salvador and Comparators, Latest Data Available



Source: World Development Indicators.

BOX 1.2 Benchmarking with Peer Countries

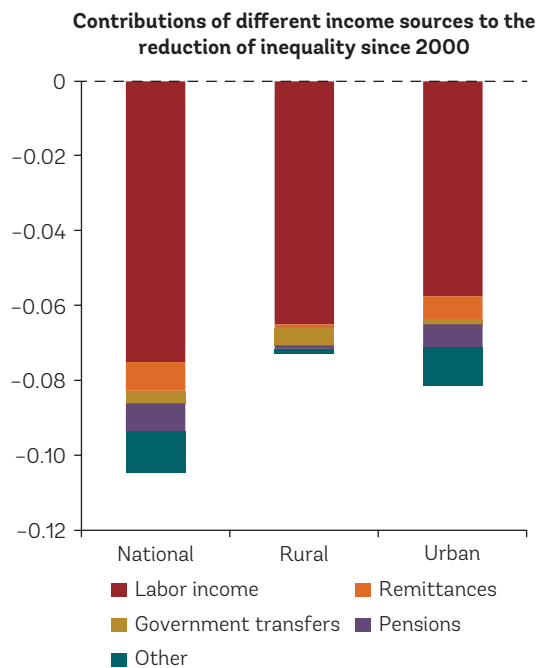
This SCD benchmarks El Salvador vis-à-vis countries in the same region (Latin America and the Caribbean), countries in the same income classification (lower middle income) and a set of structurally similar countries (“structural peers”).

Structural peers are countries anywhere in the world that meet three criteria that also define El Salvador:

- Population between 3 and 12 million (El Salvador’s population is 6.4 million)
- GDP per capita between \$2,500 and \$6,000 (El Salvador’s GDP per capita is \$3,800)
- Positive net outmigration and remittance inflows at least 3 percent of GDP

Using the above criteria the structural peers for El Salvador are: Armenia, Bosnia and Herzegovina, the Dominican Republic, Georgia, Serbia, and Tunisia. References to “Structural peers average” in this SCD indicate the unweighted average for these countries (including El Salvador).

FIGURE 1.14 Labor Income Accounts for the Decline in Inequality



Source: World Bank staff based on EHPM.

inflation rates experienced by the different deciles of the income distribution. The decrease in inequality as measured by the Gini coefficient is not the result of using a consumer price index that may mask differing trends in the prices faced by those with very different income levels. Adjusting for decile-specific inflation rates results in a lower but similar rate of reduction in the Gini coefficient since 2000. While in the standard calculation the Gini coefficient decreased by 6 percentage points using the decile-specific inflation rates results in a decrease of around 4 percentage points.⁴

The decrease in inequality was driven largely by labor income in both urban and rural settings. Nationally, labor income explains 72 percent of the decline in income inequality since 2000, while remittances explain 7 percent, and government transfers explain only 3 percent of the reduction in overall inequality. The role of the labor income

in decreasing inequality is even more important in the case of rural households, where it explains fully 89 percent of the decline in inequality and remittances only 1 percent. The limited role played by remittances despite the large volume of those transfers is explained by the fact that remittances are received by households along the entire distribution of income (as discussed further in chapter 3 on inclusion).

What was the contribution of growth?

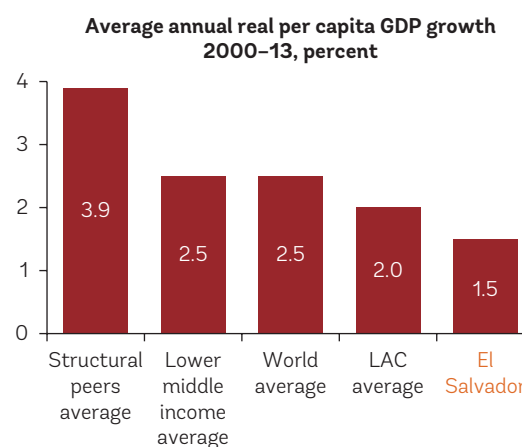
Economic growth was the main driver of the (limited) poverty reduction observed. To explore the role that growth has played in poverty reduction we perform a Datt-Ravallion decomposition of poverty changes, which attempts to identify the relative contributions of growth and changes in inequality for any given poverty change. Before the global economic crisis of 2008, when poverty reduction in terms of \$4/day took place in El Salvador, growth accounted for about 72 percent of the poverty reduction and inequality for about 28 percent.⁵ El Salvador has benefited from a high growth-poverty elasticity, especially for extreme poverty. It is estimated that during the decade of 2000 a one percent change in GDP was associated with a 2.2 percent change in extreme poverty (Cadena et al. 2013).

Given the low overall growth, the increase in the income of the bottom 40 has been unusually high. Estimates using the methodology of Dollar, Kleinberg, and Kraay (2013) suggest that the growth of the bottom 40 in El Salvador was seven times higher than predicted given its average income growth. This finding holds even if the model is re-estimated to assuming that the country

has the average pro-poor bias of the Latin American region. It is also worth noting that the income of the bottom 40 percent has grown faster than for the total population across all geographic areas as discussed above.

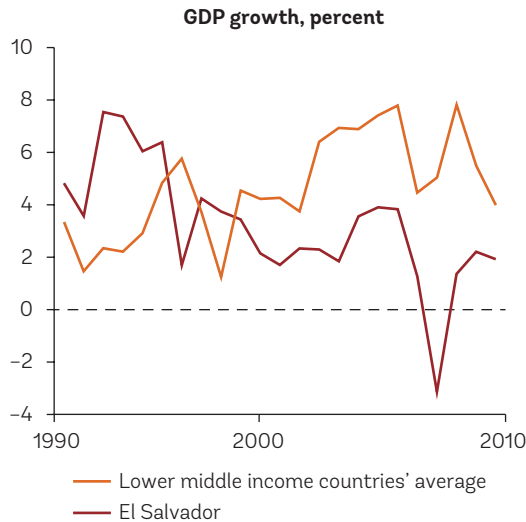
Worryingly, growth has been low for an extended period, becoming a drag on shared prosperity. Since 2000 real per capita GDP growth in El Salvador has been significantly lower than in countries with similar income levels, structural characteristics, or any of the other sets of comparators (see figure 1.15 above). For example, among its group of structural peers El Salvador's per capita GDP growth has been the lowest. Among the 48 lower middle income countries for which data is available, El Salvador ranked in the bottom quarter. Moreover, growth has been below par for an extended period of time and the trend has been one of further falling behind (see figure 1.16 above). While the impact of the global economic crisis of 2008

FIGURE 1.15 Per Capita GDP Growth in Comparator Countries Has Been Much Higher



Source: World Bank.

FIGURE 1.16 El Salvador's Growth Has Been Low for an Extended Period



Source: World Bank.

was significant, the volatility of growth has diminished over time and has not been particularly high.⁶

El Salvador's development prospects are influenced heavily by four key characteristics: a large diaspora, frequent natural disasters, high crime and violence, and the fact that the economy is dollarized. The rest of this section introduces these four key characteristics that shape both the development challenges and the space for policy interventions.

Key Country Features Affecting Development

A Large Diaspora

Around one in three Salvadorans lives abroad, especially in the US. An estimated 2 million Hispanics of Salvadoran origin resided in the United States in 2011, according to the US Census Bureau's American Community

Survey as analyzed by the Pew Research Center. Salvadorans in this statistical profile are people who self-identified as Hispanics of Salvadoran origin; meaning that either they themselves are Salvadoran immigrants or they trace their family ancestry to El Salvador. Of the 2 million self-declared Salvadorans in the US a full 1.2 million were born in El Salvador and migrated to the US, while 800,000 are descendent of Salvadoran migrants but were born in the US themselves. Even if we only consider the 1.2 million migrants born in El Salvador as the relevant stock of migrants that still implies that more than one in five Salvadorans reside in the US.

The pace of migration picked up in the 1980s in the context of the civil war and accelerated after the end of the war. Over the last three decades an average of 60,000 Salvadorans emigrated annually. While the first wave of migration coincided with the war, the pace of migration did not slow down after the peace was secured. In fact the average number of migrants per year actually increased. In the 1980s the country lost annually around 29,000 people due to migration. In the 1990s this figure increased to around 63,000 per year and remained at around 62,000 in the first decade of the 21st century. Only in the aftermath of the global economic crisis has there been a decrease in migration, averaging around 37,000 migrants per year in 2010–12, although it is too early to tell whether this is just a temporary phenomenon or a reversal of a long-standing trend. Public opinion polls indicate that 23 percent of Salvadorans intend to migrate, one of the highest levels among Latin American countries (LAPOP 2012 surveys).

Migrants are more likely to be younger, slightly more educated, and male. Around

60 percent of those that migrated did so when they were between 15 and 30 years of age (UNDP). Migrants are also slightly more educated than those left behind. The share of the population in El Salvador aged 25–55 that finished secondary school is only 31 percent. In contrast, among the Salvadoran-born population in the US aged 25–55 the share of those that finished secondary school is 45 percent (this considers only those who migrated to the US at age 18 or older so as to exclude those who may have migrated as children and completed high school in the US; data from the American Community Survey 2013). Among the 2 million Salvadorans in the US the share of men (51.5 percent) is higher than among the Salvadorans in El Salvador (where men represent only 47.1 percent of the population). A multivariate analysis of the factors explaining the intention to migrate among Central America residents—as reported by respondents to the Latin American Public Opinion Poll—provides important insights into what may be behind the decision to migrate (Hiskey, Malone, and Orces 2014). The most significant factor correlated with the intention to migrate is age, with those aged 16–29 being more likely to want to migrate. After factors related to age being a recipient of remittances, likely a proxy for an individual's ties with an active migration network, is the second most important factor correlated with the intention to migrate. Both crime and corruption victimization are also significant predictors of migration intentions, followed by gender (with males more likely to migrate, see Hiskey, Malone, and Orces 2014).

Migrating has been the path to find a job for a majority of Salvadoran youth. Because of the large number of migrants, their age

profile, and a higher propensity to participate in the labor force among migrants, it is estimated that over the last three decades two out of three Salvadorans that entered the labor force found a job outside of the country.⁷ As a result of the large migrations, the US has become a “society of reference” for Salvadorans (UNDP 2013) and the factors driving migration go beyond lack of opportunities or insecurity. The large Salvadoran communities that are well-established in the U.S. provide networks that attract and facilitate migration.

Frequent natural disasters

Disasters caused by natural events pose a significant development challenge and have regularly caused significant economic losses over the past decades. El Salvador is exposed to a variety of natural hazards, including hydro-meteorological and geophysical hazards, and has a history of destructive earthquakes, volcanic eruptions, tropical storms, and droughts. It ranked second among countries with both the highest economic risk exposure to two or more hazards as well as the highest percentage of total population at a relatively high mortality risk (Dilley et al. 2005). Between 1982 and 2005, the country had nearly 6,500 deaths and an estimated economic cost of more than \$16 billion (in constant 2008 US\$) due to disasters.⁸

Disasters due to excessive rainfall are frequent. The country is located in the sub-tropical hurricane area, thus subjected to both Atlantic and Pacific storms. Between 2009 and 2013, annual average losses from tropical cyclones were 1.1 percent of GDP. Tropical Storm Ida in 2009 caused economic losses that amounted to \$315 million (or 1.4 percent of GDP) and affected more than

three million people, while Tropical Storm Agatha caused losses of \$111 million in 2010. Most recently, Tropical Depression 12E in October 2011 affected nearly 70 percent of all municipalities and was the most severe weather event recorded in El Salvador. The population affected by the event was estimated at 1,424,091 people (55 percent of the country's population), of which more than 56,000 had to evacuate their houses. The economic damages and losses caused by Tropical Depression 12E in El Salvador is estimated at \$902 million, which represents 4.3 percent of the country's GDP in 2010. In addition, droughts have also had large socio-economic impacts, for example in 1998 and 2001, damaging the crops of 400,000 people living on subsistence incomes.

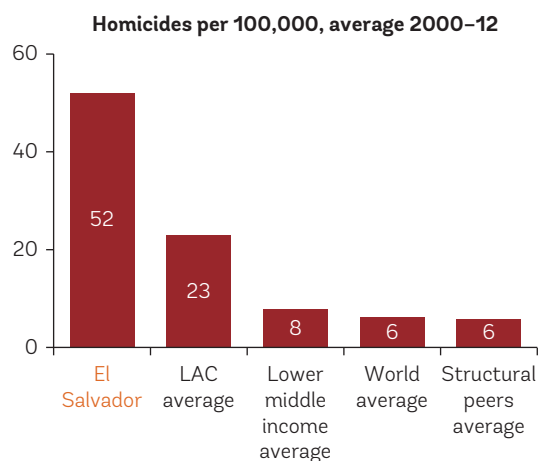
Moreover, a high percentage of its population lives along six active volcanoes and in areas highly exposed to geological hazards. The last two major earthquakes in January and February 2001 led to economic losses of \$1.85 billion, representing approximately 13 percent of El Salvador's 2001 GDP. These earthquakes killed 1,159 people and affected 1.6 million people. Other major earthquakes within the last century include those of 1986 (1,500 people dead) and 1917 (1,050 people dead). Estimated national losses from a one in a 100-year earthquake total US\$5.7 billion (25 percent of current GDP). On the other hand, the largest population centers are located close to active volcanoes. San Miguel, the second-largest city in the country with around 250,000 inhabitants, is located just 7 kilometers away from a volcano (Chaparrastique) which has had five eruptions in the last two decades. The capital city of San Salvador, with over one-third of the country's population, is also located next to an active volcano (Quetzaltepec) with a

history of large eruptions, the last of which took place in 1917.

High levels of crime and violence

Crime and violence put at risk the sustainability of social gains. El Salvador faces a particularly difficult challenge from crime and insecurity. One indicator of the severity of crime is that El Salvador has been since 2000 among the top 5 countries in the world in homicide rate (UNODC 2013; see also figure 1.17). Since 2000 the number of homicides has always been above 30 per 100,000, five times the world average, and peaked at over 60 homicides per 100,000 before a truce declared between *maras* (gangs) in March 2012. The truce has since unraveled and homicides went up again in 2014. The economic costs of violence in El Salvador are estimated to be around 11 percent of GDP including material losses, public and private security, and health costs (Acevedo 2008; World Bank 2011a).

FIGURE 1.17 Crime Is among the World's Highest



Source: UNODC 2013.

In 2010 crime overtook economic issues as the number one problem in the country as perceived by the population (see further below in the sustainability chapter). Crime is a key development issue for El Salvador.

Violence in El Salvador has multiple causes, some of which are external. First, the country's history of civil war and the widespread availability of small firearms were conducive for violence to take hold. A second key factor is the rise of the *maras*, created originally in the US among Salvadoran migrants. Many of the gang members were subsequently deported back to El Salvador, often after having served prison terms in the US. These deported gang members brought with them the *maras* to El Salvador and turn them into a criminal enterprise that attracted many disadvantaged youths in part due to the strong sense of identity that the *maras* provided. The increase in deportations from the US in recent years has also helped to expand the ranks of the *maras* in El Salvador. A third key factor is the increase in drug trafficking through Central America in recent years, with the *maras* and drug cartels now increasingly tied.² While violence is a complex issue, it is clear already from the list of factors mentioned above that many of the causes that have exacerbated violence in El Salvador have a strong exogenous component.

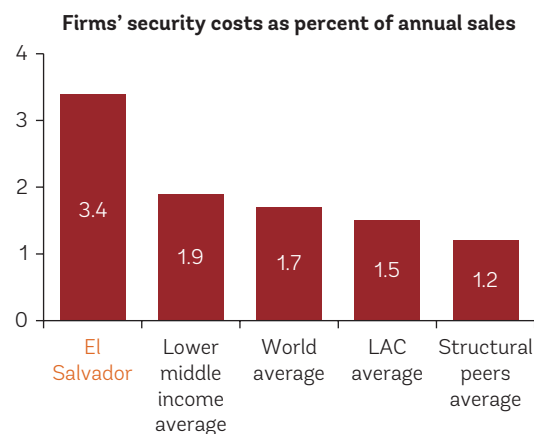
Given weak institutions, crime poses a challenge to the state's capacity to enforce the law and undermines economic sentiment. The state is not able to deliver citizen security. Impunity is high, with a criminal conviction rate of less than 5 percent. This contributes to a lack of confidence in public institutions and even concerns among some members of the public about a possible state capture. Police and the judiciary are widely

perceived as corrupt and the Supreme Court has the lowest level of citizen confidence among major public institutions. The lack of confidence in the police has led to private security personnel outnumbering the police force. Private security costs are substantial and affect the competitiveness of Salvadoran firms (see figure 1.18). Threats and extortion have become widespread.¹⁰ While hard evidence is often unavailable, existing surveys indicate that in fear of crime a significant number of small firms have responded by for example reducing opening hours. Extortion can sometimes be so high, and its enforcement so brutal, that some firms are simply opting to go out of business (see figure 1.19). Reporting to the police is rare due to lack of confidence in security institutions and fear of reprisals.

A dollarized economy

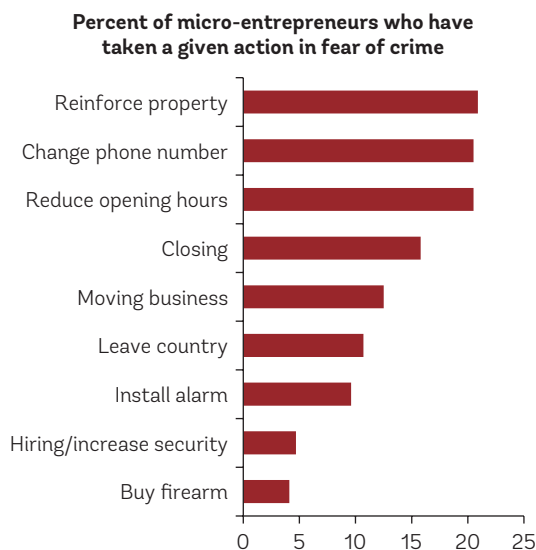
El Salvador officially dollarized its economy in 2001. From 1993 through 2000 El Salvador operated under a pegged exchange rate. As of

FIGURE 1.18 Security Costs Are an Additional Burden that Limits Competitiveness



Source: World Bank Enterprise Surveys.

FIGURE 1.19 Small Businesses Often Restrict Activity in Fear of Crime



Source: World Bank analysis of USAID survey.

January 1st, 2001 the U.S. dollar became the legal tender; the decision to adopt the U.S. dollar as the official currency was made in the context of solid macroeconomic fundamentals: inflation was low and stable, the economy was growing, public and external debt was manageable and the banking system was stable. The currency arrangement has remained stable and has not been or is under risk.

The adoption of the U.S. as currency impacted the economy in various ways. First, inflation differentials with the United States and other trading partners have remained low. Annual inflation in El Salvador has averaged 3.2 percent since 2000. Inflation is also similar for both the bottom 40 and the top 60 percent of households, averaging 3.6 and 3.8 percent p.a. since 2000 respectively.

Second, full dollarization contributed to a reduction in the level of interest rates through

the effect on the currency premium. Compared to peg, full dollarization led to a decrease of 4 to 5 percentage points in commercial bank interest rates. The corresponding net static gains for the non-financial private sector are estimated at 0.5 percent of GDP. The gains for the government from lower cost of domestic debt net of the seigniorage revenue lost are estimated at 0.25 percent of GDP (Swiston 2011).

Under the peg interest rates were determined by internal market conditions with zero pass through. Under official dollarization, pass-through of U.S. monetary policy to Salvadoran bank interest rates has been significantly stronger than under the peg. Pass-through is on par with Panama that has a very open and competitive banking system. However, the transmission of U.S. interest rates to El Salvador still depends heavily on conditions in the banking system and market views of fiscal sustainability, as these factors explain between over half of the variation in the El Salvador-U.S. interest rate gap. These results suggest that progress in fiscal consolidation and maintaining sound risk management in the banking system are crucial elements allowing El Salvador to fully enjoy the potential benefits of low interest rates and quick transmission of U.S. monetary policy to the domestic economy offered by official dollarization.

Third, while El Salvador's higher real and financial integration with the United States economy since the dollarization has been in line with that of the region over that period, the increase in the correlation with the U.S. cycle has exceeded that of the region. The correlation of year-on-year output growth has risen from minus .3 under the peg to .7 and the correlation of year-on-year inflation has risen to .8 from .3 percent. Some of this

synchronization could stem from the effects of official dollarization itself. When compared with other countries in the region operating under a peg, there is no evidence that moving to a more flexible exchange rate policy would yield sizeable improvements in terms of cyclical stabilization for the El Salvador.

Having a fully dollarized economy calls for particular attention to having a sound financial system and a prudent fiscal policy.

The absence of a lender of last resort puts additional emphasis on preventing situations of stress in the financial system. Similarly, since the authorities no longer have recourse to monetary and exchange rate policy to cushion any shocks, fiscal policy becomes the only tool through which the government can undertake countercyclical policy, making the building up of fiscal buffers during good times all the more important.

Notes

1. While poverty estimates from the 1990s are not strictly comparable, the methodological differences do not appear to drive the differences in poverty reduction observed between the two decades (Cadena et al. 2013).
2. This analysis is based on income from as estimated from household surveys. While there are differences on any given year between the survey-based household income and the gross national income as derived from the national accounts, over the period for which data is available the average growth rates of the two measures are fairly similar and in line with the relationship observed for other countries in the Latin America and the Caribbean region (see appendix for further details).
3. Analyses based on synthetic panels that follow the same households over time show even steeper growth incidence curves where the poorer parts of the distribution grow faster; see Ferreira et al. (2013, 105).
4. World Bank, *Inequality in a Lower Growth Latin America*, Semiannual Report of the World Bank Chief Economist Office for Latin America and the Caribbean, Fall (2014, 55).
5. From 2007 to 2012 changes in poverty (\$4/day) were too small to perform this decomposition.
6. The standard deviation of growth rates or of the output gap since 2000 has been lower than the average for the Latin America and the Caribbean region and similar to the average for lower middle income countries. However, growth has been so low in El Salvador that an alternative measure of volatility that takes this into account, like the coefficient of variation, shows a slightly different picture whereby El Salvador has been affected by greater volatility than other countries in Latin America and the Caribbean (see appendix).
7. See UNDP (2013, 95). The number is so high that it is worth explaining it in detail: during the last three decades each year 20,000 people entered the 15–30 year old group in El Salvador, of which around 11,000 were employed. In comparison, of more than 60,000 migrants each year around 36,000 were in the 15–30 year old group. Given a labor force participation rate of 77 percent among Salvadoran immigrants in the US and an unemployment rate of 10 percent among Salvadoran migrants in the US (CEMLA, BID, and FOMIN 2013), it can be estimated that during the last three decades every year around 24,000 Salvadorans aged 15–30 became employed in the US.
8. The use of the term “natural disasters” is to be understood as disasters triggered by natural events since in fact a disaster only arises once the natural event meets human activity, and in particular inadequate location of housing, inadequate infrastructure, etc. Disasters can often be prevented (or at least minimized) by improving land use planning, construction standards, etc.
9. World Bank (2011a) and Shifter (2012) provide a good overview of the growing literature on violence in Central America. However, this literature still suffers from limited quantitative information that could allow robust

empirics. For an early attempt at conducting such empirical work see Cruz, Argüello, and Gonzalez (2001).

10. The homicide rate dropped sharply from 70 per 100,000 inhabitants in 2011 to 36 in 2012 and 39 in 2013 as a result of a truce between

maras. However, robbery, extortion and threats reported by individuals in surveys before and after the truce show almost identical levels of victimization: 23 percent in 2011 and 24 percent for the May 2012–April 2013 period (IUDOP 2014).

2. Determinants of Economic Growth

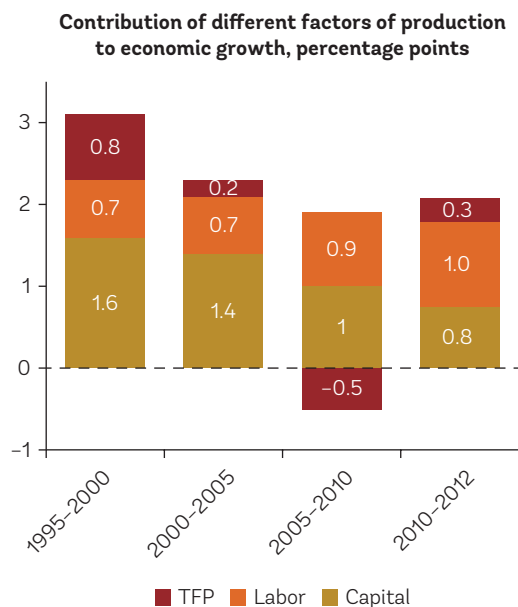
Drivers of Growth

GROWTH ACCOUNTING DECOMPOSITIONS suggest a modest contribution to growth of total factor productivity (TFP) and a declining one from capital. Over the last two decades the slowdown of growth can be attributed to decreasing contributions to growth of both capital and TFP while the increase in the contribution of labor has not been enough to offset the other factors (see figure 2.1). The decreasing contribution of capital and TFP is the result of a low and declining rate of capital accumulation. El Salvador stands out for both a lower investment rate than its comparators and its downward trend (see figure 2.2).

As of 2013 gross capital formation stood at around 14 percent of gross domestic product (GDP), putting El Salvador in the bottom decile of countries worldwide. Both public and private investment is low (see figure B.9).

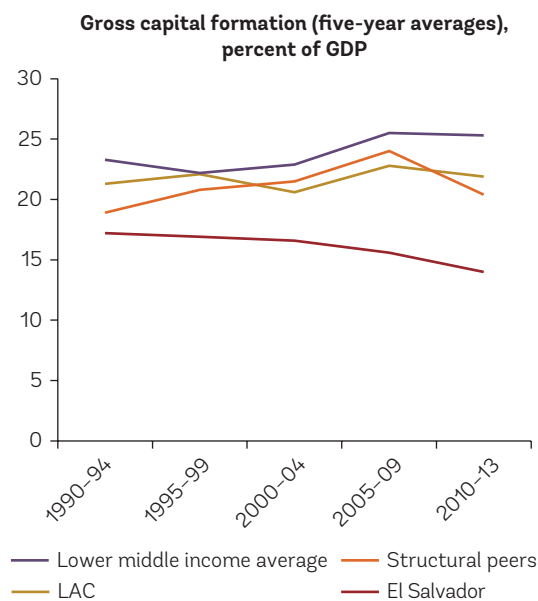
High consumption drives growth and fuels import growth. Consumption as a share of GDP reached 102 percent of GDP in 2013, a value which is higher than any of the comparator countries and among the highest in the world. Exports stood at 41 percent of GDP while imports amounted to 61 percent of GDP. The gap between the shares of exports and imports continues to widen as import growth continues to outpace exports. From 2010 to 2013 imports grew at 2.5 percent p.a. while

FIGURE 2.1 Low Contribution of Total Factor Productivity to Growth



Source: World Bank.

FIGURE 2.2 A Declining Contribution of Investment



Source: World Bank.

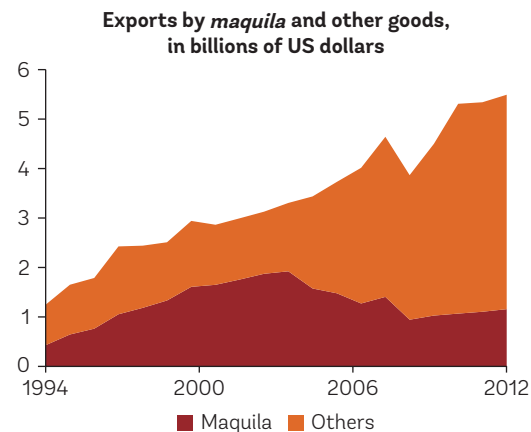
exports grew at 1.5 percent p.a. Growth has been sluggish across all economic sectors. With the exception of mining, a sector which accounts for less than 1 percent of GDP, no sector has grown above 3 percent p.a. in the period 2010–13. Among the best performing sectors are construction, which grew at 2.3 percent p.a., and government services, which grew at 2.8 percent p.a. Among the largest sectors of the economy, manufacturing grew at 1.5 percent p.a. and retail and hospitality grew at 1.8 percent p.a.

While growth is low across the board, tradables underperform non-tradables. El Salvador opened up its economy significantly in the 1990s. The average tariff came down from 22 percent in 1990 to 2.5 percent in 2000 and has fallen further since. At the time of this opening up it was expected that El Salvador would benefit from its access to world markets. Initially, *maquila* exports, typically textiles assembled in El Salvador for export to the US, soared.¹ Starting in the mid-2000s, however, competition from other countries started to

erode the competitiveness of Salvadoran *maquila* exports, which started to fall in absolute terms (see figure 2.3). While other exports have picked up since they have not done so at a fast enough rate to compensate the decline in *maquila* exports. Few firms enter the export market when compared to other countries (Lederman et al. 2014, 12). As a result, and despite the openness and outward orientation of El Salvador (with exports plus imports over 100 percent of GDP), the growth of exports has not kept up with its comparators (see figure 2.4).

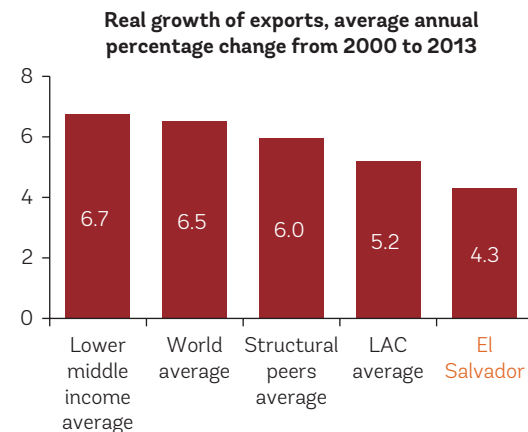
The pressures of external competition on manufacturing have led to fewer jobs in manufacturing. Employment in services has grown but with lower productivity. While the economy still retains a relatively large manufacturing base, relatively few jobs are being created in manufacturing. At its peak manufacturing accounted for 33 percent of employment but has since dropped to 27 percent (see figure B.5). As jobs in services have a lower labor productivity than in services this structural

FIGURE 2.3 The Rise and Fall of *Maquila*



Source: World Bank.

FIGURE 2.4 Underperforming Export Growth



Source: Central Bank of El Salvador.

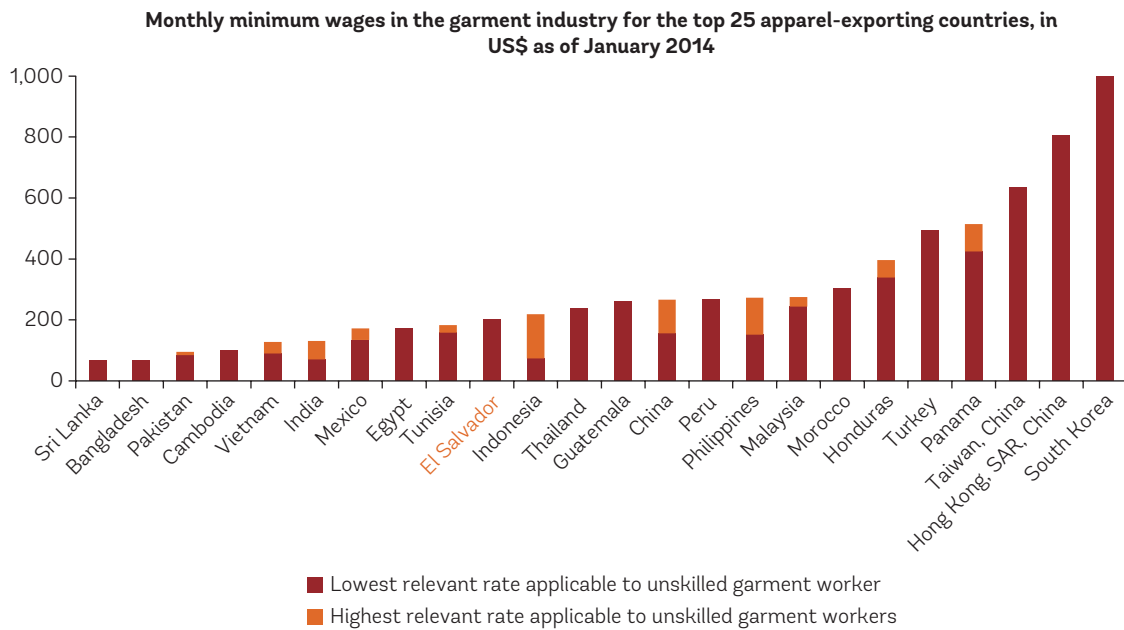
transformation has actually decreased productivity.

The decline in textile *maquila* exports is due in part to increasing competition from lower wage producers. Among the top 25 apparel-exporting countries in the world El Salvador's wage costs are in the middle of the range (see figure 2.5). There are numerous garment producing countries with wages that are significantly lower than in El Salvador. For example, minimum wages for garment industry workers in India or Vietnam are one-third lower than in El Salvador. This implies that for the textile industry to be competitive in El Salvador it needs to specialize in higher value activities. The presence of relatively high wage producers among the top 25 apparel-exporting countries in the world (as shown in figure 2.5) suggests that it remains

possible to be competitive in the industry provided higher productivity is achieved.

And competitiveness has been undermined. There are many indicators that competitiveness is under pressure. Among the few Salvadoran firms that enter the export market El Salvador has the second-lowest exporter survival rates among a set of 29 countries for which comparable data is available (see Lederman et al. 2014). Another sign of a limited competitiveness is the fact that exports are concentrated in terms of products, destinations, and firms.² The different evolution of the tradables and non-tradables sectors is also indicative of the competitiveness pressures on tradables. Prices and salaries in tradable sectors are falling relative to non-tradables while productivity in tradables outpaces non-tradables (see figure 2.7).

FIGURE 2.5 There Are Global Competitors in the Garment Industry with Lower Wage Levels



Source: ILO 2014.
 Note: Singapore does not have a minimum wage and is omitted.

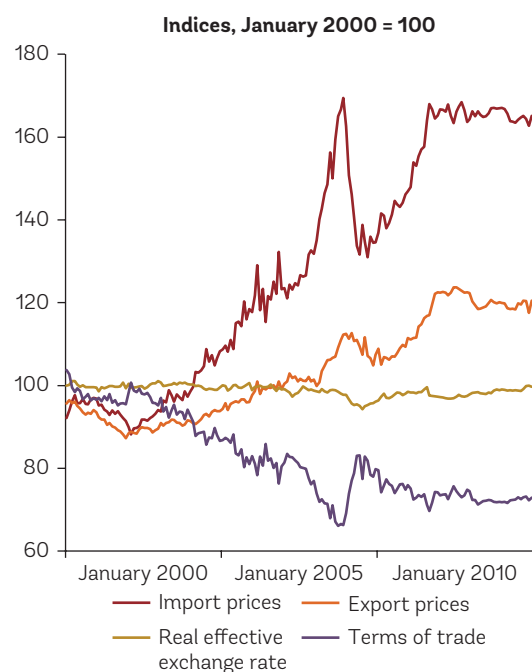
Negative terms of trade have contributed to the underperformance in tradables. The rise in oil prices during the 2000s and downward price pressures on textiles from global competition led to an overall negative evolution of El Salvador's terms of trade over the last decade (see figure 2.6 below). In addition to worsening terms of trade the increased competition globally has led to a decrease in volumes of Salvadoran textile exports. A volume index of *maquila* textile exports set at 100 in 2005 declined almost continuously over the following years and dropped to 64 in 2013.

As the country has experienced a real exchange rate appreciation. The real effective exchange rate measured using inflation remains stable. However, taking into

account the evolution of productivity and wages suggests that the real exchange rate, which had been undervalued in the 1990s, appreciated over the last two decades and is no longer undervalued (Cabrera 2014). In fact, recent estimates of the equilibrium real effective exchange rate suggest an overvaluation up to 9 percent and a cyclically-adjusted current account deficit about 1 percent of GDP higher than its equilibrium value (IMF 2015a).

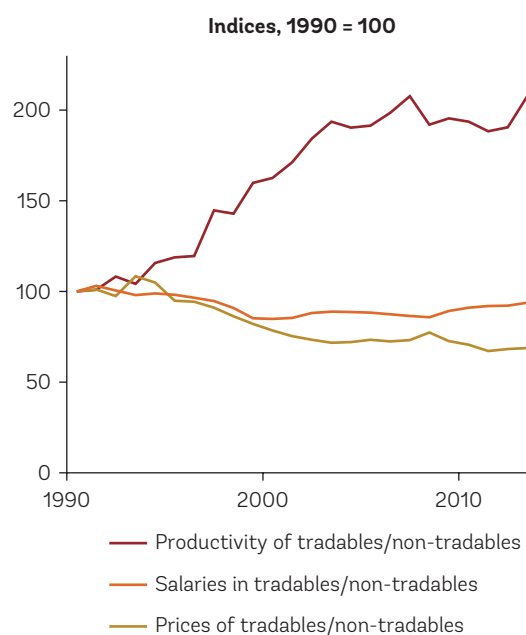
Given the eroding external competitiveness the limited foreign investment that has been attracted has focused on serving the domestic market. The model under which the *maquila* in El Salvador was developed was one of attracting foreign direct investment (FDI) inflows based on relatively low

FIGURE 2.6 Terms of Trade and Real Effective Exchange Rate



Source: Central Bank of El Salvador.

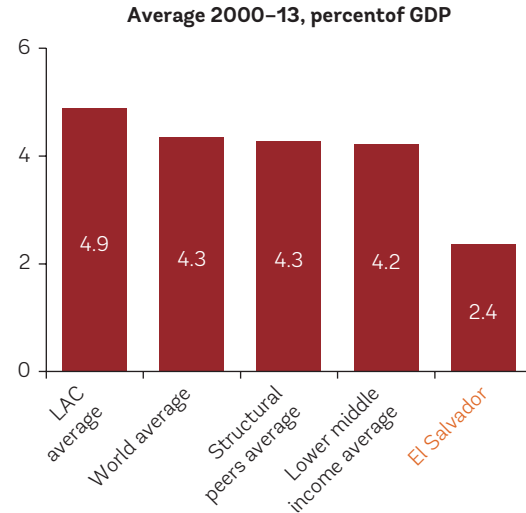
FIGURE 2.7 Competitiveness Pressures Are Felt More Strongly on Tradables



Source: Cabrera 2014.

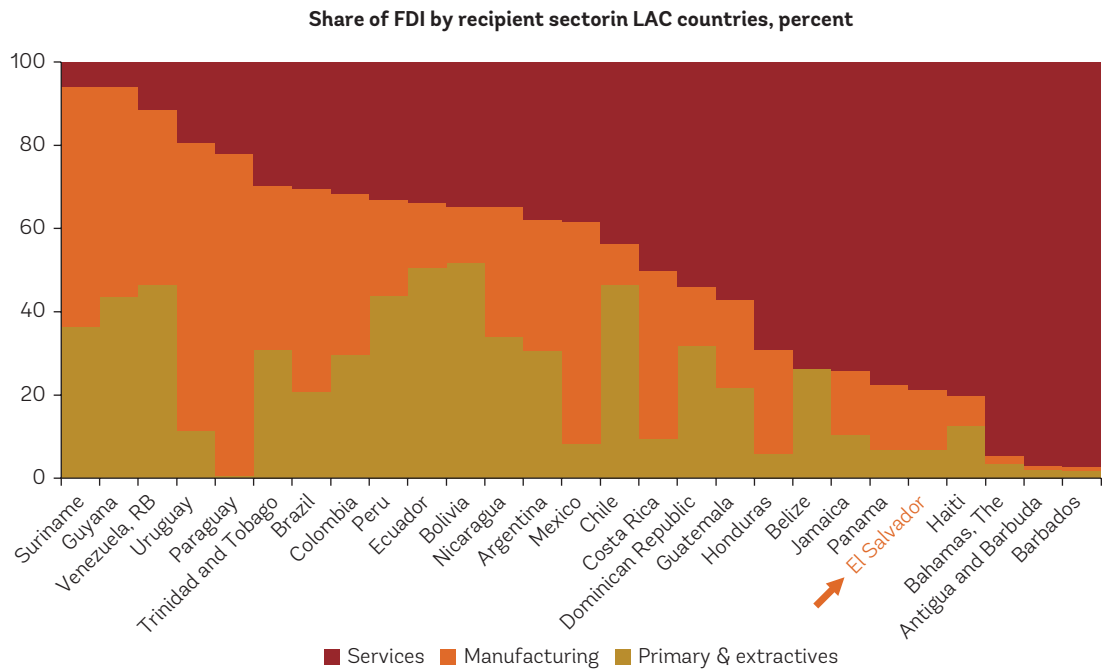
wages, tax incentives, and special access to the US market. Such a model was fast eroding in the early 2000s as the US opened its market to new competitors (ECLAC 2003). Attracting FDI has proved to be challenging. El Salvador stands out as having attracted much less FDI than its comparators since 2000 (see figure 2.8). FDI inflows are also lower than a benchmark value estimated from a regression that controls for population and GDP (Lederman et al. 2014, 124). In addition, close to 80 percent of the FDI inflows have gone into the services sector, with little in the manufacturing or primary and extractive sectors (see figure 2.9). When the country opened up it was expected that FDI would focus on export-oriented activities rather than on the domestic services

FIGURE 2.8 Foreign Direct Investment Is Low



Source: World Bank.

FIGURE 2.9 Foreign Direct Investment Is Focused on the Tertiary Sector to Serve the Domestic Market



Source: World Bank Chief Economist Office for Latin America and the Caribbean, Semiannual Report (April 2014).

sector as it happened in the 2000s. A recent analysis of FDI, including a survey of would-be investors, identified that the existing tax incentives are no longer effective and a broader competitiveness agenda is required.³

What Are the Factors that Constrain Growth the Most?

A review of existing analyses points to low investment as the proximate cause for low growth

The low economic growth that has characterized El Salvador in recent decades has been the focus of much study. El Salvador was one of the first case studies of the “growth diagnostics” methodology (Hausmann and Rodrik 2005). These authors highlight the relatively few number of new products that enter the export basket of El Salvador as evidence of a lack of “self-discovery” of new industries by Salvadoran firms. Low investment is identified as a binding constraints to growth in El Salvador but cannot be attributed to a lack of savings given that returns to capital were low. Low investment is therefore attributed to low returns on projects.

Low investment and the corresponding low productivity growth are the most cited causes of the growth performance of the country (Acevedo 2003; Central Bank of El Salvador 2005; Zegarra et al. 2007). But many other factors have been put forward as additional explanations for the stagnation of the Salvadoran economy. Unfavorable terms of trade, natural disasters, and slow labor accumulation are also factors often discussed in the literature (Cabrera, Fuentes, and de Morales 2005). The heavy reliance on remittances

coupled with the high share of consumption in GDP has led analysts to label the Salvadoran economic development model as one of promoting the import of consumer goods and the export of labor (UNDP 2013). Some have gone on to argue that the opening of the Salvadoran economy has been excessive and is at the root of the poor economic performance (Cáceres and Flores 2013).

A more recent growth diagnostics concludes that there are two binding constraints to growth: security/crime and low productivity of the tradables sector. An analysis of constraints using the growth diagnostics methodology was undertaken by the US and Salvadoran Governments as part of their Partnership for Growth (USG-GoES 2011). This updated growth diagnostics concludes that there are two binding constraints to growth: security/crime and low productivity of the tradables sector. The analysis, however, added the caveat that more data was needed to establish the criticality of constraints on credit to small and medium enterprises (SMEs), climate change, government effectiveness in commerce and justice, education, and migration.

The World Bank has also produced a number of analyses focused on growth in El Salvador. The 2003 Country Economic Memorandum benchmarks El Salvador against Latin America and the Caribbean (LAC) countries on a range of growth determinants and identified savings and investment rates as particularly low. It then concludes on the importance of improving the conditions for investment (including addressing insecurity and infrastructure), fostering innovation, increasing foreign trade, and improving education. In the 1995 Country Economic Memorandum constraints to growth in El Salvador are explored by comparing it with fast growing Asian countries. It documents negative TFP growth and

concludes on the need to increase physical and human capital, openness, and productivity. The remainder of this section updates some of the work on the determinants of growth in El Salvador.

Why is investment low?

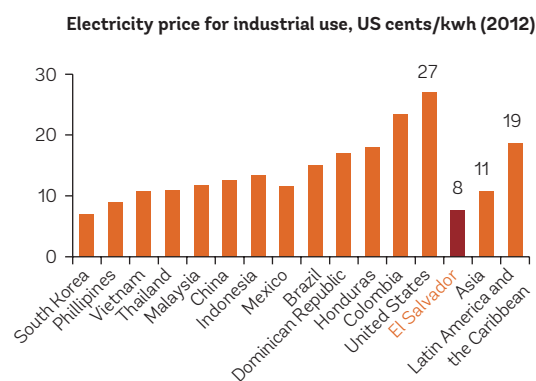
Returns to capital are low. Leaving aside the issue of whether savings may also constrain investment, to which we will return later, the available evidence suggests that returns to capital have often been below real interest rates (USG-GoES 2011, 27). Capital productivity, as estimated from a growth accounting framework, has been declining since 1995; in addition, while regular data on capacity utilization is not available, an estimate suggests that the under-utilization rate of capital may be around 54 percent (Amaya and Cabrera 2013). The view that returns to capital are low has long been identified as a factor behind low growth in El Salvador.⁴

As firms face low revenues and high costs, including energy. Firms face high costs of production in a number of areas. Regarding energy, in part due to the high dependence on oil,

which accounts for 36 percent of electricity generation, electricity prices are high—especially for industrial users (see figure 2.10 above). Although the energy sector was privatized in the 1990s the small size of the domestic market and the regulatory framework have been factors limiting new investments in this area that could have diversified energy sources and brought prices down.⁵ Recently collected data on product market regulations suggests that the regulatory framework in El Salvador may not be as conducive to competition among electricity generators as in other countries. For example, in El Salvador third-party access conditions to the electricity transmission grid are subject to negotiation, rather than regulated, which can limit the entry of new market players in the electricity generation market.

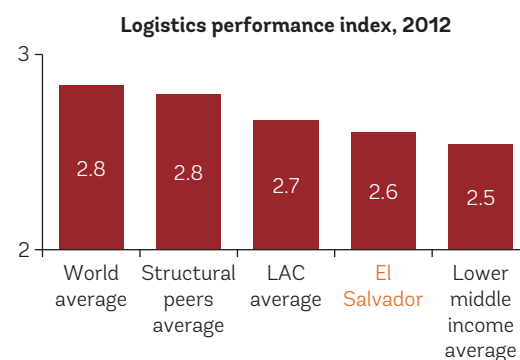
Transport and logistics costs are also high. In the 2012 logistics performance index ranks El Salvador below the averages for many of its comparators (see figure 2.11 below). Similarly, the UN liner shipping connectivity index ranks El Salvador 92nd of 155 countries. Available data suggests that it costs more to ship a container from the East coast of the US

FIGURE 2.10 Energy Costs Are High



Sources: World Bank LAC Regional Study on Energy Pricing (forthcoming). Data for El Salvador from CNE table 6, Q1 with information of SIGET bulletin 2013.

FIGURE 2.11 Inefficient Logistics Is a Barrier to Exploit the Proximity to the US



Source: World Bank.

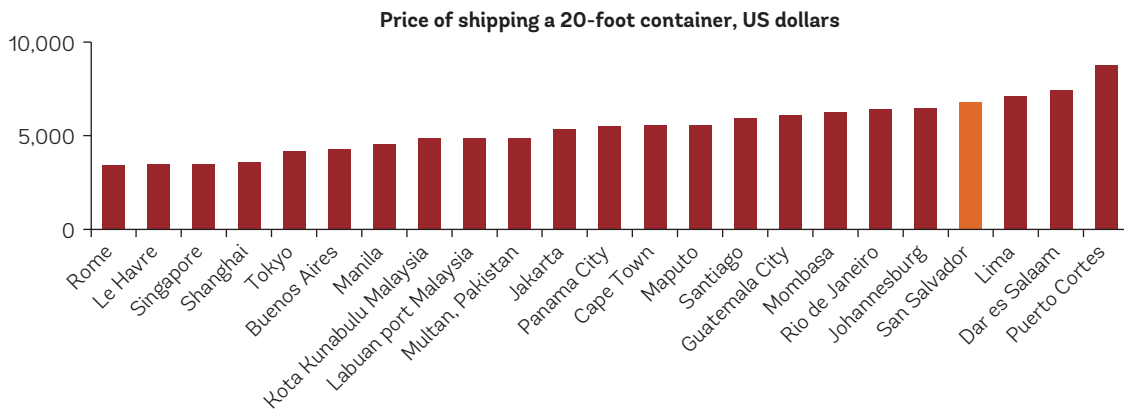
to San Salvador than to many ports in Asia (see figure 2.12: It costs more to ship a container from Baltimore to San Salvador than to many Asian destinations). In part this is due to the lower volumes of shipping necessarily associated with a small market size but also reflects an overall limited efficiency of the sector. Port reform is still pending and performance of the main port of Acajutla lags that of other ports in the region. For example, a recent econometric analysis of the technical efficiency of ports in Latin America and the Caribbean ranks Acajutla 54th out of 67 ports analyzed, with an efficiency score of only 23 percent (where the efficient technical frontier is set 100) (Morales Sarriera et al. 2013).

Limited competition also affects transport and logistics costs. Carriers on many international routes are organized into cartels—so-called liner conferences—that confer on shipping prices and market shares, with significant impact on trade volumes. A recent study finds that eliminating the ability of cargo carriers to price above marginal cost would boost trade volumes in Latin America by

15 percent (Hummels, Lugovsky, and Skiba 2009). However, inefficiencies in transport and logistics also play a role. In trucking, for example, border frictions, wait times, traffic congestion, high empty backhaul, informal payments, and crime and insecurity all contribute to raising costs of road freight substantially.⁶ Air transport also presents potential barriers to competition as regulations give room for incumbent airlines to influence new entry through a public consultation phase during the approval process of air traffic right applications.

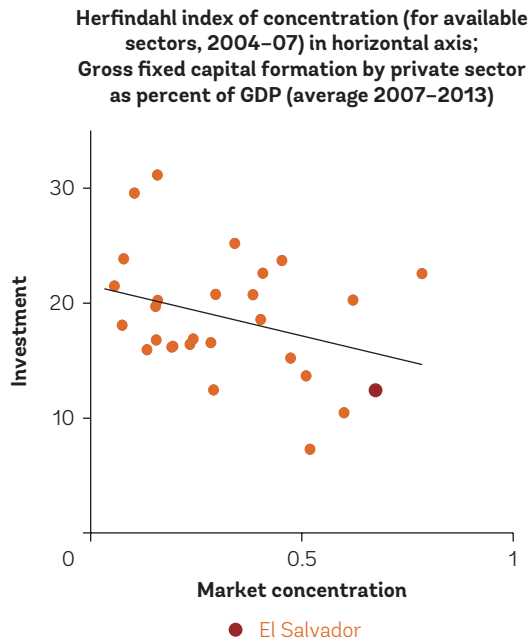
Several markets in El Salvador are unusually concentrated, even for a small economy, which is consistent with data on barriers to entry and rivalry.⁷ There is limited firm entry in El Salvador compared to other countries, (see figures 2.13 and 2.14 below) which may contribute to lower investment.⁸ The evidence suggests in fact a higher degree of market concentration in non-tradable industries in El Salvador than in most countries, ranking third out of 71 countries in terms of concentration.⁹ Measures of product market regulations also suggest that there is scope

FIGURE 2.12 It Costs More to Ship a Container from Baltimore to San Salvador than to Many Asian Destinations



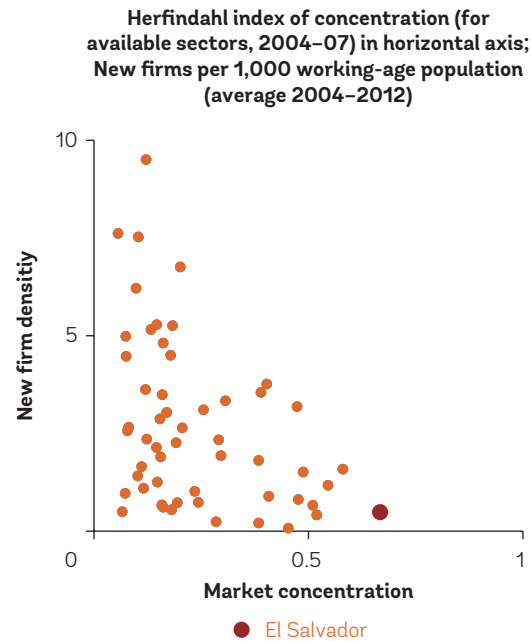
Source: Quoted Prices from shipping-worldwide.com for 10 MT 20 foot container (39 cubic meters) valued as \$20,000 (dry goods).

FIGURE 2.13 Low Investment Is Correlated with High Market Concentration across Countries



Source: World Bank.

FIGURE 2.14 Fewer Firms Are Created in Countries with High Market Concentration



Source: World Bank.

for increasing competition. The agricultural sector presents examples of legal barriers to market entry and business expansion. For example, a state agency establishes sugar production quotas on the basis of historic production, limiting incentives to potential market entrants. Additionally, privileged access to tariff quotas at 0 percent for rough rice deters potential competition, resulting in a concentrated market structure over the last decade.

Advocacy work of the Competition Agency also shows the importance of removing barriers to competition in key sectors. The Competition regulatory agency has been able to influence important policy changes: incumbent airlines are no longer exempt of financial guarantee requirements and scheduled flight operators can no longer block permits

for charter flights. The agency also prevented a provision that would have allowed the public authority responsible for supervising the public accountants' profession to deny applicants new licenses based on a subjective and potentially discretionary evaluation of the applicant's "professional aptitude." Finally, sanitary registrations guarantee public health, but they should not constitute a barrier to competitors entering the market and providing products at better prices. Following the agency's opinion, the acknowledgment of foreign sanitary registrations from countries with high sanitary standards was implemented, so as to increase competitive pressures on the incumbents in the Salvadoran market of pharmaceuticals (World Bank 2014b).

KNOWLEDGE GAP How Does Limited Domestic Competition Affect Shared Prosperity?

Measures of product market regulations, data on firm creation, and available microeconomic studies such as the one on the trucking industry, air transport, electricity and agriculture sectors, all suggest some room for increasing competition in El Salvador. This may be one of the reasons behind limited innovation in the country, as illustrated for example by the fact that the percentage of firms introducing a new product in a given period is fewer in El Salvador than in the majority of countries for which this data is available (Lederman et al. 2014, 8). Limited competition is likely affecting innovation and the ability to enter export markets, undermining the growth potential and therefore job prospects. In addition, limited competition may push domestic prices up and thus undermine welfare for the population as a whole, including the bottom 40 percent of the income distribution. For example, in 2008 the national Regulatory Agency for Competition detected a cartel agreement between the most important wheat flour companies. This market-sharing agreement was particularly harmful for consumers as an average household in El Salvador spends 13 percent of its total consumption on bread. However, there is limited evidence that documents systematically how competition conditions affect in practice shared prosperity.

Limited competition increases the prices of services on which industry relies and contributes to a stagnant productivity growth in services. There is also microeconomic evidence on the impact of limited competition on the prices of non-tradables. This is the case of trucking, discussed above, and where despite there being many trucking companies, the degree of competition varies by route because of domestic restraints on competition and the prohibition on international competition on national routes. Research shows that imperfect competition accounts for at least one-third of trucking prices on national routes (Osborne, Pachón, and Araya 2014). Combined with the macroeconomic level data this evidence suggests that El Salvador suffers from too little competition. Limited competition, together with regulatory issues, contributes to a stagnant productivity of the services sector in

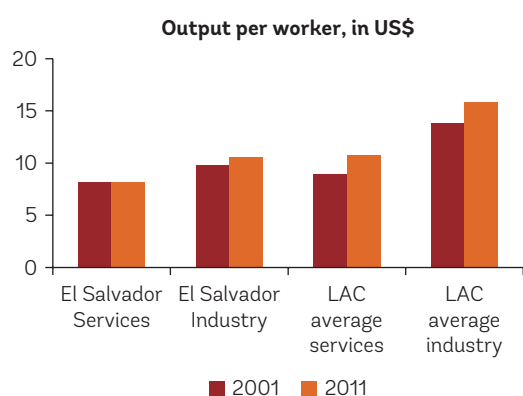
El Salvador, where output per worker remains effectively flat over the last decade (see figure 2.15). Since the structure of the economy has been moving away from manufacturing and towards services the type of structural transformation that has happened in El Salvador has decreased productivity.

Salvadoran firms are characterized by undertaking little innovation. A number of indicators point to a rather limited innovative activity. For example, according to the 2014–15 World Economic Forum Global Competitiveness Index, El Salvador was ranked 121 (out of 144 economies) based on patent applications per capita. Given the low degree of competition observed in El Salvador a plausible hypothesis is that limited competition contributes to a lack of innovation, undermines competitiveness and negatively impacts shared prosperity. An analysis of the factors

that may account for the innovation gap in countries in Latin America and the Caribbean point to a number of likely potential culprits in the case of El Salvador, including limited competition in tradables, limited human capital for innovation, and insufficient contractual certainty (Lederman et al. 2014, 150).

The lack of strong economic linkages between the free economic zones and the rest of the economy is also contributing to the low level of innovation. The type of garment assembly *maquila* that was developed in El Salvador has long been characterized as creating limited linkages with the local economy and with little potential to generate spillovers.

FIGURE 2.15 Stagnant Productivity in Services



Sources: WDI, ILO stat, and UNCTAD stat.

The type of firms involved in these labor-intensive industries tend to operate with a short-term time horizon, invest little in productivity and skills development and basically compete on price (ECLAC 2003). In fact, evidence from the input-output table confirms that *maquila* producers rely less on domestic suppliers of intermediate inputs. For every \$100 worth of *maquila* production *maquila* producers buy domestically produced inputs worth \$37, while manufacturing other than *maquila* buy \$50 worth of domestically produced inputs for every \$100 worth of output (see table 2.1).

While access to finance does not appear to be a constraint for larger firms, bank finance for SMEs is limited. According to the 2010 World Bank enterprise survey (WBES), the vast majority of urban formal firms have a deposit account, and nearly a half of surveyed firms have a line of credit, yet just 21 percent had investments financed by a bank, and 19 percent through supplier credit. SMEs were 1.5 times as likely as large firms to identify access to finance as a key constraint for their business operations. Consumer credit, which often has simpler documentation requirements, is often used by many micro and SMEs to fund their business, albeit at higher interest rates. As in other countries in Central America, the share of credit to SMEs in total

TABLE 2.1 Backward Linkages of Different Economic Activities

	Maquila (textiles and apparel)	Manufacturing	Services	Other goods
Value added	42	32	68	51
o/w labor contribution	21	11	25	20
o/w capital contribution	21	21	43	31
Domestically produced intermediate inputs	37	50	23	42
Imported intermediate inputs	21	18	9	8

Source: World Bank staff calculations using Global Trade Analysis Project's (GTAP) Social Accounting Matrix for 2011.

Note: Manufacturing refers to manufacturing other than the textile sector.

bank portfolio has declined while consumer credit has increased. At an average of 166 percent the value of the loan, collateral requirements limit access to credit for many firms, particularly smaller firms.

The securities markets of El Salvador are too thin to play a significant funding role for corporates. Market capitalization is high compared to peers in Central America (45 percent of GDP), due to the legal framework that requires financial institutions (banks and insurance companies) to list. However, in practice, there have been very few initial public offerings (IPOs). Comparatively the private bond market has exhibited more dynamism and to date there are 54 corporates with outstanding issues. In addition, other debt instruments are starting to develop, including the first securitization issues. Pricing is a key challenge given the limited trading of all these securities, and the lack of a medium to long term yield curve. As of September 2011, pension funds' assets amounted to roughly \$6 billion. About 85 percent of their assets continue to be invested in public securities, due to regulatory requirements but also due to the lack of investable domestic securities. From the demand side, pension funds are the largest institutional investors. Structural challenges, such as the size and ownership structure of companies and the level of savings, impede further development, although elements of the current market architecture do create burdensome processes and transaction costs.

The investment climate environment has not kept up with reforms in other countries. In the early 2000s the country made significant improvements in starting a business, registering property, trading across borders, and getting credit. In fact, El Salvador led reform efforts in Latin America and the Caribbean in the early 2000s. El Salvador's best ranking

in the Doing Business indicator was 69th in 2008. Since then, however, it has dropped every year and currently stands at 118th in the 2014 ranking.¹⁰ The drop in ranking is largely associated with other countries making reforms not with a worsening of the business environment in El Salvador in absolute terms.

Frequent changes of the tax system do not help to create an investment-friendly business environment. Investors are attracted by simple, stable, and predictable tax systems which are administered in an efficient and transparent manner (OECD 2010). The tax system in El Salvador has undergone 13 tax reforms between 2008 and 2011.¹¹ While these efforts have contributed to alleviate the fiscal situation—a concern discussed in chapter 4 on sustainability below—it is also important to strike the right balance between revenue raising efforts and providing a stable and predictable tax system. While tax reforms in the last years have helped to broaden the tax bases there is still room for improvement. Efforts to broaden the tax base and limit evasion could pave the way for some reduction in tax rates, for example for corporates, since at 30 percent for corporations with income higher than \$150,000 the rate is relatively high compared to other countries and may affect the attractiveness of the country for investors.

Insecurity not only increases costs but also raises concerns about the appropriability of returns and dampens economic activity. In addition to paying for private security costs, which as noted in figure 1.18 above are among the highest in the world, the impact of crime and violence affects businesses in other ways. The collection of extortion payments operates with relative impunity and affects many sectors of the economy. In a survey of 425 relatively large firms in 2013, 37 percent of respondents reported being the victims of

extortions (*Encuesta de Competitividad Empresarial*). Smaller businesses located in more marginal areas are particularly affected by this problem and suffer extortion rates that can be up to 50 percent of their revenue.

Some businesses are simply exiting the marketplace in fear of crime. There is increasing survey evidence that fear of crime, and in particular extortions, prompts some businesses to exit from the marketplace altogether (see also figure 1.19 above). The issue of security is a concern not only for employers but also for workers and consumers. Over 40 percent of the population reports having changed their shopping and recreation habits in fear of crime and over 5 percent changed jobs due to fears of crime (LAPOP 2012). Among businesses surveyed by the *Encuesta de Competitividad Empresarial* 25 percent reported having cut investment plans. Among the population as a whole, security is identified by 65 percent of Salvadorans as the most important problem facing the country (LAPOP 2014).

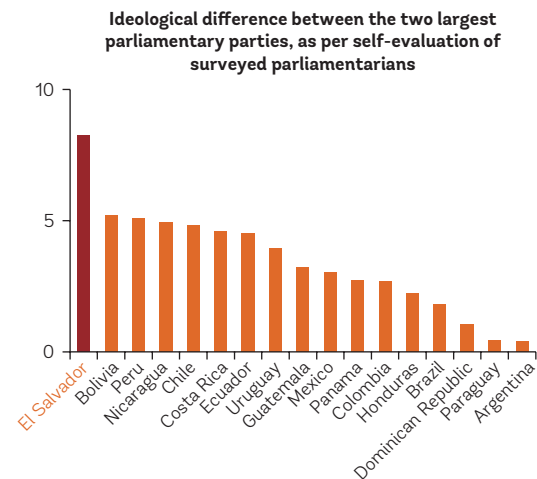
Concerns about the appropriability of returns to investment are also fueled by lack of trust in the government and a perception of instability. Despite having had peaceful democratic transitions of power since the peace agreements of 1992, political instability is still ranked fourth among the obstacles mentioned by firms in the latest Enterprise Survey. Trust in state institutions is also undermined by insecurity.¹² Rule of law indicators have not significantly improved over the last two decades according to the Worldwide Governance Indicators. Trust in the legislative and political parties is among the lowest of all institutions in the country. El Salvador ranks 135th (out of 144 countries) in public trust in politicians (2012–13 Global Competitiveness Report). Surveys often highlight fears of policy instability among the highest concerns of the

private sector. In this regard, it is important to stress that actual policy changes have been relatively modest. Yet despite having had policy stability perceptions of instability remain.

A highly polarized political climate in Congress likely contributes to the perception of instability. More than two decades after the end of the civil war political polarization remains high. The traditional two parties, ARENA and FMLN, remain seen as ideologically opposed to each other as in the past. In fact, the self-assessed ideological differences between the two parties the Salvadoran parliament suggest that it is the most polarized in Latin America (see figure 2.16).

The polarization in Congress reflects to some extent that of the society at large. El Salvador is in fact a society where relatively few people declare themselves to be in the political center. As shown in figure 2.17 below, the percentage of Salvadorans that declare themselves to be from the extreme right and

FIGURE 2.16 The Salvadoran Parliament Is the Most Polarized in Latin America



Source: World Bank staff calculations based on surveys of Programa de Élités Latinoamericanas of University of Salamanca.

KNOWLEDGE GAP The Paradox of a Widespread Perception of Corruption but Low Bribe Payments

The data collected through various sources (Latino Barometer, Latin American Public Opinion Poll, Worldwide Governance Indicators, Enterprise Surveys) report widespread corruption (by citizens and businesses). For example, 87 percent of respondents feel the police is corrupt or extremely corrupt and 81 percent feel the judiciary is corrupt or extremely (Transparency International's 2013 Global Corruption Barometer for El Salvador). According to the Enterprise Surveys 60 percent of Salvadoran firms consider corruption as a major constraint in doing business, compared to 40 percent on average in Latin America. However the actual percentage of respondents reporting to pay a bribe is about 11 percent—a low number and in contradiction with the widespread perception of corruption. A few factors could help explain this apparent contradiction in the data:

1. Respondents may be reticent to admit to have paid a bribe (a well-known phenomenon recently studied by Kraay and Murrell 2013);
2. An open and lively press may influence respondents and bias them toward believing that corruption is more widespread and common than what it is in reality;
3. Bribe payment is only one form of corruption and this may not be the most common and/or threatening to the country. Other forms may be more common (like nepotism or corruption in public procurement or elite capture) that have not been captured in the existing surveys

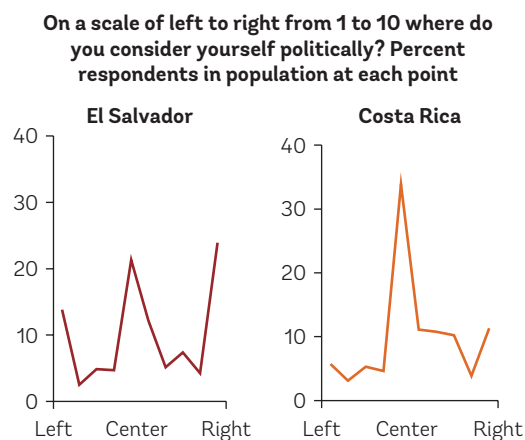
To reconcile this apparent contradiction it would be important to gather additional data on different types of corruption present in the country. The data collection should be detailed and rich enough to explore whether firms of different size and/or located in different provinces and/or working in different sectors are more or less affected by different types of corruption. This exercise could help understand the most significant challenges faced by firms and identify clear policy measures to address them. It would also help better understand the extent and the mechanisms through elite capture by a small group of vested interests may be operating in the country.

the extreme left are relatively high, forming a W-shape of political leanings among the population which contrasts with the patterns observed in other countries where the center is the preferred option of a significant portion of the population and extreme positions are a minority. Overall, political polarization

makes it difficult to reach consensus even on policies that would appear to be relatively uncontroversial and makes governing a challenging task.

In addition to the above discussion, to identify the key constraints to unlock economic growth in El Salvador is also helpful to review

FIGURE 2.17 Salvadoran Society Is Also Polarized, with a Shallow Political Center



Source: World Bank staff calculations based on LAPOP.

a variety of comparative studies available in the literature that can inform the identification of the areas that could have held growth back and could therefore have the highest impact on growth methods. Thus, prior to identifying the key priority areas for boosting growth we also review, in turn cross-country benchmarking, and micro and perception data.

Cross-country benchmarking

Cross-country regressions have been commonly used to identify the determinants of growth. Growth regressions are used to identify which of a large number of factors are statistically and economically significant determinants of growth rates. Cross-country growth regressions provide a useful input for the analysis. Of particular interest are studies that not only estimate the determinants of growth but also benchmark the performance of individual countries in Latin America for each of the explanatory variables. In this regard,

two sources are particularly useful. The first one is a study of economic growth in LAC by Loayza et al. (2005). The second one is a forthcoming LAC regional study by Araujo et al. (2014) which updates and builds on the work by Loayza et al. (2005) and increases the sample in terms of country coverage and time period.

In a first step, these analyses estimate the impact of the explanatory variables on economic growth in a large panel of countries, taking into account potential biases. The analyzed explanatory factors include: transitional convergence (initial GDP), cyclical reversion (initial output gap), structural policies in areas such as education, financial depth or public infrastructure, and stability policies, such as lack of price stability or cyclical volatility. In both cases, the impact of these factors on economic growth is analyzed relying on system General method of moments (GMM) estimation, an econometric estimation technique that takes into account unobserved country-specific effects and joint endogeneity of the explanatory variables (growth drivers) with the dependent variable (economic growth) in a dynamic model of panel data. Loayza et al. (2005) uses an unbalanced panel of 78 countries with non-overlapping five-year observations that span the period from 1961 to 1999. Araujo et al. (2014) expands the sample to 126 countries using five-year non-overlapping panel data from 1970 to 2010.

The estimation results can give a sense of the relative importance of the factors behind growth; however, important limitations of the approach have to be taken into account. First, as for any econometric estimation, the results may be biased due to omitted variables; second, instruments used for the GMM estimation may be mis-specified; and third, the

proxies for the explanatory factors may not adequately capture the actual concept that is being analyzed. Given these limitations, the results from the econometric analysis are cross-checked with additional analyses and country-specific knowledge to form a plausible overall picture.

In a second step, a benchmark exercise explores the growth that a country could have achieved if it were a top performer in terms of each of the explanatory variables. This type of counterfactual exercise highlights the areas with the largest impact on per capita income for a given country. This is the approach followed by both Loayza et al. (2005) and Araujo et al. (2014), although with slightly different specifications. The scenarios studied in Loayza et al. (2005) correspond to a hypothetical situation in which the determinants of growth in each country would improve to be on par with the top 25 percent of the countries. In Araujo et al. (2014), one of the scenarios considered corresponds to an improvement in the determinants of growth to the 90th percentile of LAC. This helps determine the possible effects that a stellar performance (relative to the rest of LAC) in specific policy-sensitive areas might have had for a country's level of GDP per capita. In addition, Araujo et al. (2014) consider what would be the impact on GDP per capita if the determinants of growth were to improve to the average levels observed in OECD countries.

The analysis by Loayza et al. (2005) suggests that education, infrastructure, and the government burden have the largest impact on growth in El Salvador. Improving education performance to the top 25 percent of Latin American countries is estimated that it could contribute an additional 1 percentage point to GDP growth while bringing infrastructure to that level would add 0.4 percentage points of GDP. In contrast, stabilization policies, financial depth and external conditions would have a much smaller impact.¹³

The analysis by Araujo et al. (2014) suggests that growth would pick up most from reforms to enhance El Salvador's openness, infrastructure, financial depth, and education. The finding that greater openness could lead to higher growth, in turn driven by El Salvador's underperformance in exports, is consistent with the analysis on the loss of competitiveness presented above. As in the case of Loayza et al. (2005), there is no significant impact on growth from an improvement in variables related to macroeconomic stabilization, reflecting the fact that El Salvador has already achieved a high degree of macroeconomic stability.

Perception data

Microeconomic survey data can provide further insights into the key constraints to growth. Data collected through the WBES in particular provides a wealth of information about

TABLE 2.2 Top Obstacles to Growth (As Reported by Firms)

	2006	2010
Top five concerns of firms	<ul style="list-style-type: none"> • Crime, theft and disorder • Practices of the informal sector • Corruption • Access to finance • Electricity 	<ul style="list-style-type: none"> • Practices of the informal sector • Crime, theft, and disorder • Access to finance • Political instability • Inadequately educated workforce

Source: World Bank Enterprise Surveys.

the experience of firms and what may prevent them from growing. The Enterprise Surveys, two of which were conducted for El Salvador (2006 and 2010), provide useful data on the perceptions of firms about what they experience as key constraints to growth. Perception data from the WBES suggest a number of areas that are to some extent aligned with the results of the cross-country benchmarking (see table 2.2). This is particularly the case for the lack of an adequately educated workforce (education in the cross-country benchmarking) and electricity (infrastructure in the cross-country benchmarking).

Firm-level econometric analysis

But Enterprise Surveys provide much more than just perception data. A second type of data collected in these surveys is objective in nature. Importantly, this data relates to both firm performance (e.g., sales, employment, and productivity) and investment climate constraints (e.g., how much does a firm pay in bribes, as opposed to the perception of a given respondent on the extent of corruption). The availability of these objective measures help nuance some of the findings. For

example, in the case of corruption—one of the top two obstacles—the 2010 Enterprise Survey shows that the percentage of firms who pay bribes is relatively small.

The econometric analysis of firm-level data helps to shed light on the areas that would have most impact on growth. Because of the availability of objective measures of firm performance and of the seriousness of investment climate constraints, it is possible to estimate econometrically the relationship between investment climate characteristics and firm productivity. This is the exercise that Fajnzylber and Lopez (2008) undertake using a pooled sample of more than 10,000 firms from across Latin America. Similar caveats apply as mentioned for the econometric analysis of the benchmarking part of the analysis.

Results from the micro-econometric analysis suggest that regulatory compliance, security, crime, and bribes are the areas that would have the most impact. Regulatory compliance captures the effect of regulation and institutional quality and is proxied by three variables that are likely to be a reflection of excessive or arbitrarily enforcement of regulations.

TABLE 2.3 Emerging Focus Areas to Boost Growth

	Cross-country benchmarking		Micro survey data			Emerging focus areas
	Loayza et al. (2005)	Araujo et al. (2014)	2006 Enterprise survey	2010 Enterprise Survey	Micro-econometric analysis	
Areas that would have the most impact	Education Infrastructure Government burden	Openness Infrastructure Finance Education	Crime Informality Corruption Finance Electricity	Informality Crime Finance Political instability Education	Regulatory compliance Security Crime Bribes	Crime Education Finance Infrastructure Governance (capturing regulatory compliance, informality, political instability, and openness)

Emerging focus areas from the comparative studies

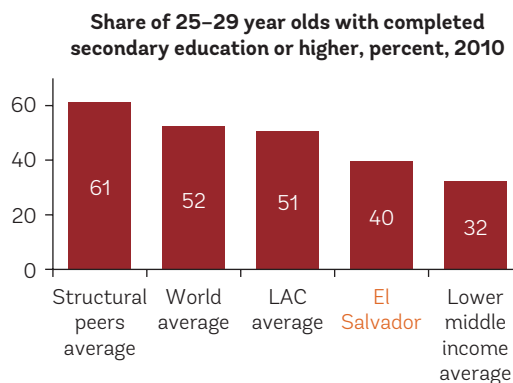
Different sources suggest a broad range of areas that have undermined growth, including education, crime and violence, access to finance, infrastructure, and state capacity or regulatory compliance (see table 2.3). The cross-country benchmarking exercise concluded that improvements would mainly come from education, infrastructure, as well as structural reforms that could result into greater exports and trade openness. The analysis of microeconomic survey data highlighted crime and violence and regulatory compliance. Some issues such as crime, education, and access to finance were raised in most of the analyses. There were however, a number of factors that were raised in some but not all analyses, perhaps due to the use of different methodologies and definitions.

Identifying Policy Areas to Increase Growth

TAKING ALL THE ANALYSES REVIEWED above, including the country-specific discussion as well as the review of the comparative studies, helps us to identify the following broad areas that could have the most impact on growth:

Reducing crime and violence—which can help alleviate a vicious circle between violence, high costs, low productivity and low investment, and low growth. A strategy to reduce crime and violence is necessarily long-term and must target an enhanced accountability of government, greater transparency of the public actions to contain impunity and the strengthening of the judicial system. On the one hand it is critical to increase the costs to individuals from undertaking criminal activities. On the other hand it is

FIGURE 2.18 Secondary School Completion Is Very Low



Source: World Bank.

essential to increase the benefits to them from engaging in productive activities. In the short to medium term, there are entry points around creating income and learning opportunities to steer the youth away from joining criminal organizations, providing incentives and skills for gang members to exit, and working with imprisoned populations to facilitate reinsertion into society.

Education: quality and access—This can boost skills and enhance competitiveness and ultimately growth. While the issue of education will be discussed in greater detail in the chapter on inclusion below, it is important to stress at this point that higher learning outcomes would better equip the youth for the acquisition of skills necessary in the domestic market or in the markets where people migrate. The low retention rates at the secondary level is an issue where El Salvador stands out as having very low completion rates (see figure 2.18). The education entry points and long-term objectives have been amply studied and discussed. They include pre-school education, improving teacher skills and capacity, measuring outcomes,

introducing IT and English language, and tailoring and expanding the existing vocational and training institutions to respond to the needs of the market. The diaspora could also provide trained personnel that fits the needs of the market—e.g., language skills.

Addressing financial inclusion can help break the vicious circle of low growth, and low savings and investment. Although interest rates are low, access to credit by small and medium enterprises is constrained, limiting the expansion of these employment-intensive sectors. The low level of use of banking services by the population makes savings difficult. Fourth, El Salvador is one of the countries in the region with less knowledge-intensive business services (technical and quality services, research and development activities, and professional services). Improvements in this area will also help Salvadoran entrepreneurs move away from business models that rely on low-cost competition to those that rely on more innovation and productivity increases, as well as attracting foreign firms interested in pursuing higher value added activities.

Improving the availability of productive services, including energy, connectivity, and knowledge-intensive services would help improve competitiveness and boost growth. El Salvador's infrastructure stock compares relatively well in some key indicators such as access to electricity, telecom access or the share of paved roads (see table B.3). However, the

challenge is often with regard to the cost of the services. First, in electricity the challenge is to reduce costs over the long haul and to diversify supply to reduce vulnerability. Local technology is available to increase geothermal supply, there is considerable potential for wind power, and installations that manage liquefied natural gas can help reduce the cost of energy. Second, regarding connectivity, the bases are in place to generate rapid gains. The expansion of the airport in San Salvador will ease the pressure that has been building as demand is outstripping capacity. Greater competition in cargo transportation by road can reduce costs. Improvements in customs are needed to facilitate trade within the Central American market. Third, improving access to information technology infrastructure, such as broadband, could help make the most of the strong links that El Salvador has with large markets such as the US.

Forging a political consensus to build a transparent and effective state would help across a number of areas. The limited capacity of the state stands as a major constraint to growth, employment and poverty reduction. Inadequate institutional designs favor opaque practices that hide objectives, designs and outcomes. The lack of transparency limits efficiency and prevents the dialogue and analysis to improve them. Bringing about desired institutional transformations will take time, but immediate actions in selected areas may help trigger the process of reform.

Notes

1. In 2005 the US accounted for 84 percent of all *maquila* exports and 90 percent of *maquila* exports to the US were of textile products. Before 2004 data on *maquila* exports was not disaggregated by country of export or product.
2. Two destination markets account for 90 percent of exports and only 15 firms generate 37 percent of exports (Berti 2014). The origin of exports is also concentrated (see appendix). The Herfindahl index of exports in 2009–11 was 0.05, lower than the averages for LAC,

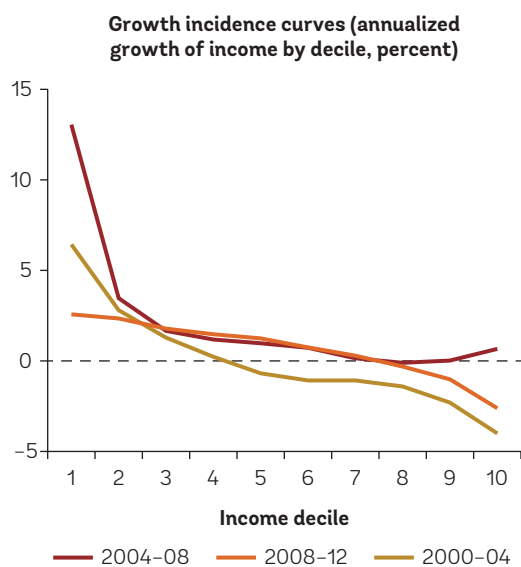
- lower middle income countries, and the world (0.17, 0.23, and 0.21 respectively) but higher than the average for the structural peers (0.04)
3. El Salvador Investment Reform Memorandum (World Bank 2015b).
 4. Hausmann and Rodrik (2005, 69) noted that “Low investment, associated with low perceived returns to capital, is therefore both a cause and a symptom of the economic challenge that confronts El Salvador.”
 5. The disappointing lack of investment in electricity generation was already discussed in the World Bank’s 2005 Investment Climate Assessment which noted the high degree of uncertainty regarding the expected returns of investment. The reason was that remuneration of generators was based exclusively on the basis of the spot price for energy, providing a return on invested capital of marginal producers only sporadically when prices are high due to limited supplies from hydro resources.
 6. Road freight prices are particularly high at 26 cents per ton-kilometer on national routes and 13.5 cents internationally, rates that stand out even relative to other inefficient markets (Osborne, Pachón, and Araya 2014).
 7. Although there is no empirical evidence on the effect of the size of the economy on trade and competition policy, theory suggests that when trade barriers are lifted, competition policy plays an important role in facilitating trade by tackling anti-competitive behavior that hinders entry of foreign importers and export of products from within national boundaries Gal (2009).
 8. Evidence from OECD countries shows that regulatory reform of product markets is associated with an increase in investment, with entry liberalization playing a particularly important role (Alesina et al. 2005).
 9. The concentration is not only higher than in other countries but also higher than a “benchmark” estimate derived from a regression analysis to control for a number of variables that could potentially influence the market concentration index that one would normally expect in a given country (Lederman et al. 2014, 17).
 10. The rankings of a given year are not strictly comparable with previous years due to changes in the methodology over time (which could imply revisions to the rankings of previous years) and to slight changes in the number of countries covered.
 11. The changes were of four types: (a) creation of new taxes on specific goods, (b) increases of income tax rates, (c) expansion of the tax base (elimination of some VAT and personal income tax exemptions), and (d) strengthening of tax and customs administration. The tax system has four main taxes and contributions: taxes on real estate transfers, VAT, special taxes on consumption to be discouraged, and income taxes. Although dominated by VAT, a recent study by FUNDE shows that the tax system in El Salvador is neutral or slightly progressive following the changes in the tax system in 2009 (FUNDE 2013).
 12. Political system support is negatively correlated with being a victim of a crime or corruption, as well as with higher education (LAPOP 2012).
 13. As is common in the literature, both Loayza et al. (2005) and Araujo et al. (2014) classify the determinants of growth in different categories, including structural factors—such as human capital or infrastructure—and those determinants of growth that are related to stabilization policies—such as inflation. Similar results to Loayza et al. (2005) are found by Swiston and Barrot (2011), whose results suggest that investment and education would have the greatest impact on growth.

3. Analysis of Inclusion

Drivers of Inclusion

THE INCREASE IN THE INCOME of the bottom 40 and the decline in income inequality noted above have been the result of faster income growth among the poorest. El Salvador stands out for having seen higher growth of incomes at the bottom of the income distribution (see figure 3.1). While household surveys may not capture well the highest incomes the faster growth of earnings at the lower end of the distribution is still noteworthy, especially given that many other countries (where the same concerns about the representativeness of the household survey data apply) show a different pattern. Despite these gains for the bottom 40, the total share

FIGURE 3.1 The Income of the Poorest Has Grown Faster than the Rest



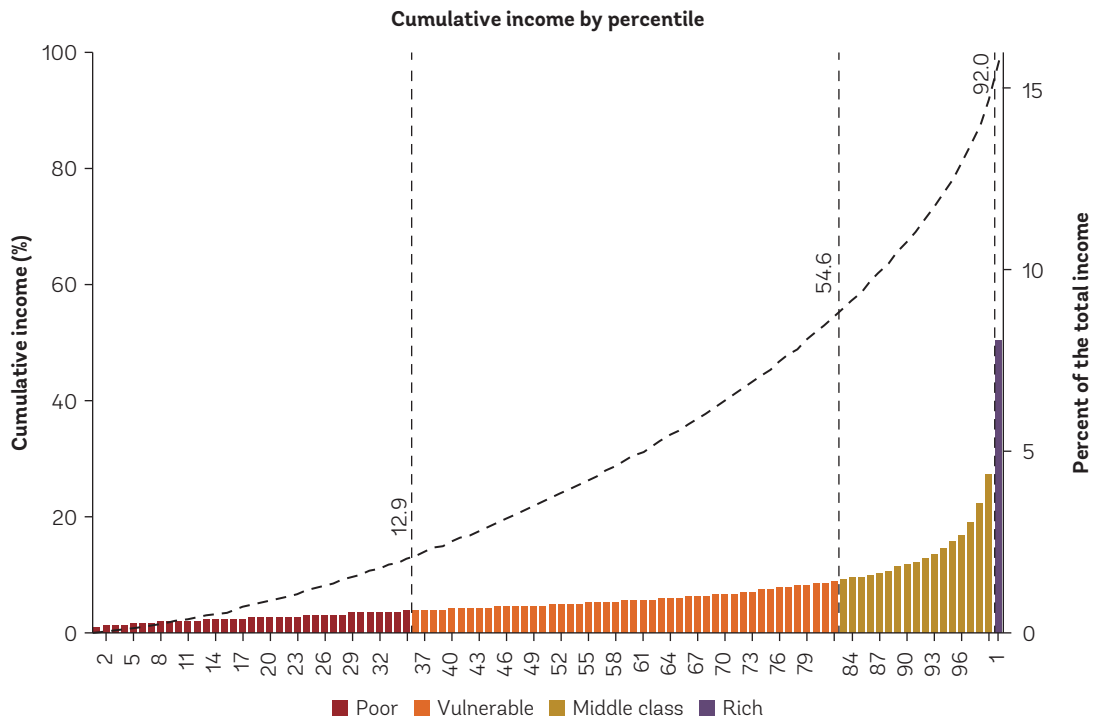
of the income that they account for remains only 16 percent (see figure 3.2).

The role of the labor market in boosting shared prosperity

Earnings growth has been limited, although slightly higher than the average for households that are rural, less educated, and headed by men. Between 2007 and 2012 rural households saw an annual growth rate of earnings of around 3.9 percent, higher than the 0.8 percent recorded for urban households. While this led to some convergence in earnings, median individual earnings in rural households (\$180/month in 2012) were still significantly below those for urban households (\$250). Earnings grew also faster among households whose head had less than secondary education completed, further flattening the curve on returns to education. Households headed by men saw slightly higher growth in earnings than those headed by women.

An analysis of the households that exited poverty shows that upward mobility is limited across all sectors. An analysis of a synthetic panel of households indicates that only 5 percent of households were upwardly mobile, in the sense that they had been poor in 2004, escaped poverty by 2007, and remained out of poverty in 2012. Upward mobility was higher among rural households (8 percent) than among urban households (4 percent). However, chronic poverty (households which were poor throughout) was much higher among rural households (40 percent) than among urban households (18 percent). Chronic poverty was also higher among households headed by someone with

FIGURE 3.2 Still, the Bottom 40 Account for Only 16 Percent of Total Income



Source: World Bank staff based on EHPM.

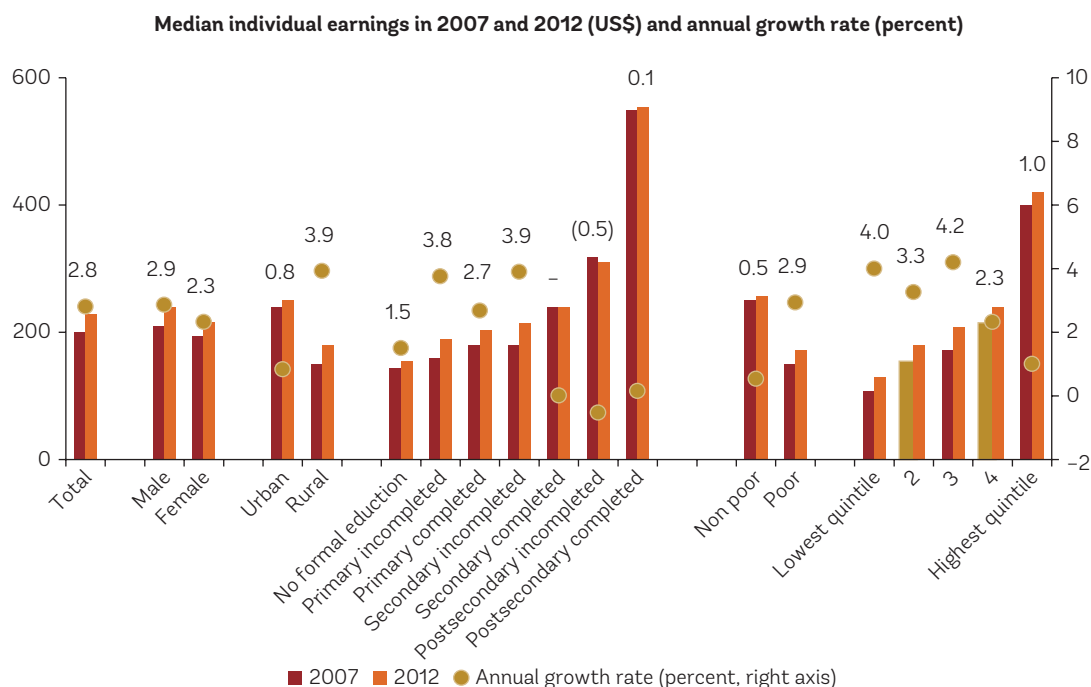
only primary education and those employed in agriculture, and slightly higher among male-headed households.

Upward mobility required large increases in income but small negative income shocks were enough to push people back into poverty. Moving out of poverty was associated with substantial income growth—from 28 to 45 percent, depending on location. In contrast, a much smaller fall in income, around 10 percent, was enough to push a household into poverty. Households in and out of poverty experienced substantial income growth but the level of income growth was not enough to lift them out of poverty. As shown in figure 3.4 those that escaped poverty were in almost all cases from the second quintile, indicating that poverty depth among those in

the lowest quintile is a particular challenge. More broadly, the asymmetry of mobility and income growth also highlights the importance of the challenge of vulnerability.

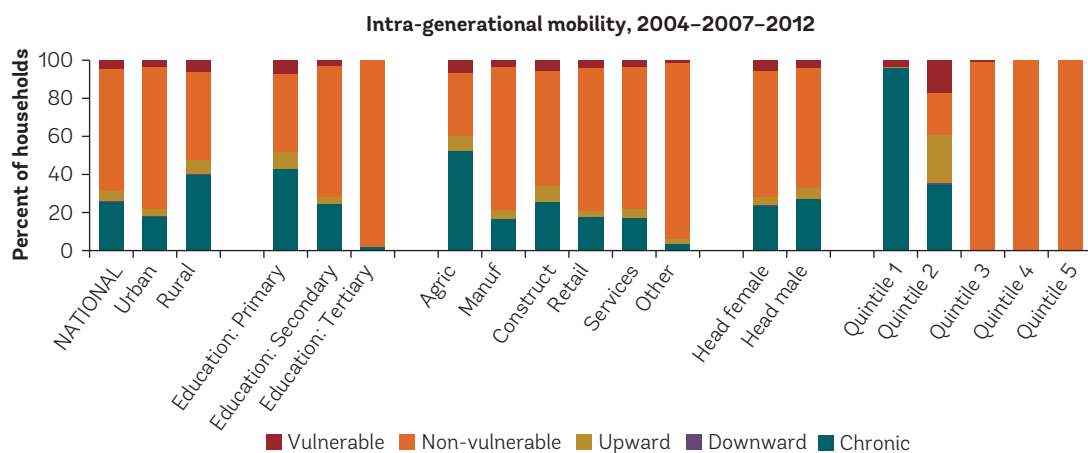
Unemployment is more frequent among the poor. With open unemployment hovering around 6 percent one of the main concerns regarding the labor market in the country is underemployment. Still, unemployment is a particular challenge for the poor and especially for the extreme poor. The latter suffer an unemployment rate that is twice the national average (see figure 3.5). Male unemployment rate, at around 7 percent, is significantly higher than female (4 percent). Rural and urban unemployment rates are broadly similar and depending on the year it varies on which one is slightly higher than the other.

FIGURE 3.3 The Growth in Earnings Has Been Faster for the Poor, Rural, and Less Educated



Source: World Bank, Central Bank of El Salvador, and US Bureau of Labor Statistics.

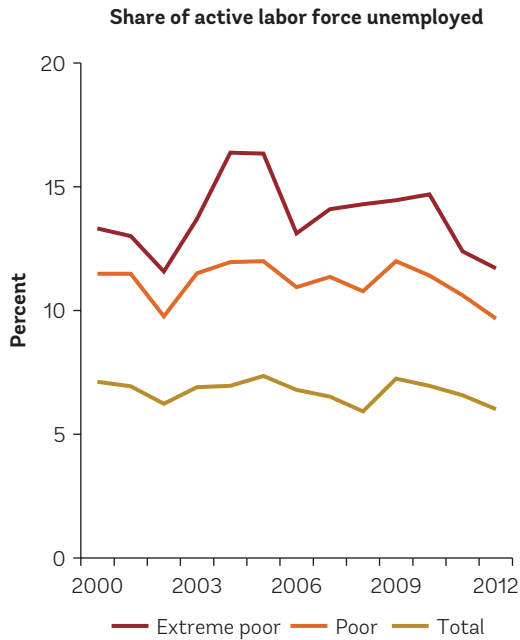
FIGURE 3.4 Upward Mobility Is Limited across All Sectors of the Economy



Source: World Bank staff calculations with data from SEDLAC.

Note: Lower bound estimates using synthetic panels constructed as in Dang et al. (2011). Chronic refers to households who were poor in all three periods (income below US\$ 4 a day per person PPP). Upward refers to households poor in 2004 but not-poor in both 2007 and 2012. Downward refers to households non-poor in 2004 but poor in the following two periods. Vulnerable are those that have moved into and out of poverty. Non-vulnerable those who have been non-poor throughout. Education, sector and gender variables refer to the characteristics of the head of household in 2004.

FIGURE 3.5 Unemployment Is More Frequent among the Poor

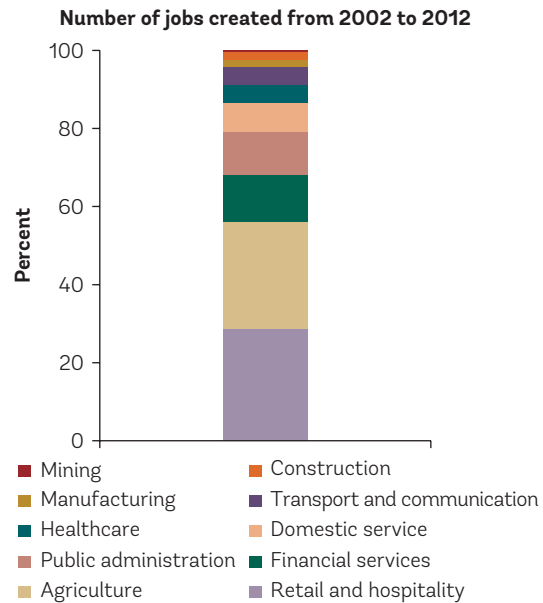


Source: DIGESTYC.
Note: All definitions are official.

Returning to the issue of underemployment, one of the main challenges is the high degree of informality, with over half of the urban working population being informal.

Job growth has taken place in relatively low wage sectors. Employment has grown at around 1 percent p.a. since 2000, in line with what one could expect given the low economic growth. Median earnings have increased little (up from \$216/month in 2007 to \$228/month in 2012) and job growth has taken place in relatively low wage sectors. Job growth has taken place mainly in the tertiary sector, where labor productivity is declining (see figure 3.6 below).¹ In the last decade the sector that increased employment the most was retail and hospitality, which created over 110,000 additional jobs. Since the 2008 crisis employment in agriculture

FIGURE 3.6 Since 2002 Retail & Hospitality and Agriculture Account for Half of All Jobs Created

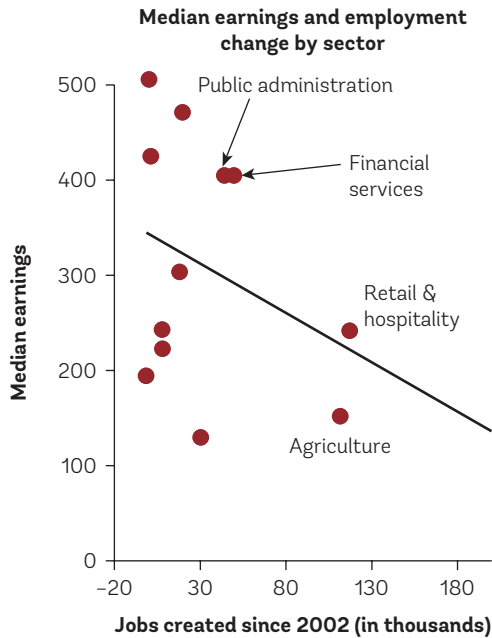


Sources: World Bank (Social Sector Expenditure and Institutional Review, forthcoming) and Central Bank of El Salvador.

has rebounded, although it is still far from its levels in previous decades and remains, like retail, a low wage sector. Among higher wage sectors only financial services in the private sector and the public administration added more than 40,000 jobs in the last decade.

Jobs in retail and hospitality and agriculture are often unable to lift workers out of poverty due to the low earnings associated with those jobs. While since 2002 job growth has taken place mainly in retail and hospitality and in agriculture the low wages typically earned in those sectors make it difficult to escape poverty by working in them. An analysis of the sector of employment of upwardly mobile households and those that remained chronically poor shows that retail and hospitality and agriculture are the two sectors of employment which are more represented

FIGURE 3.7 Most Jobs Have Been Created in Low Wage Sectors



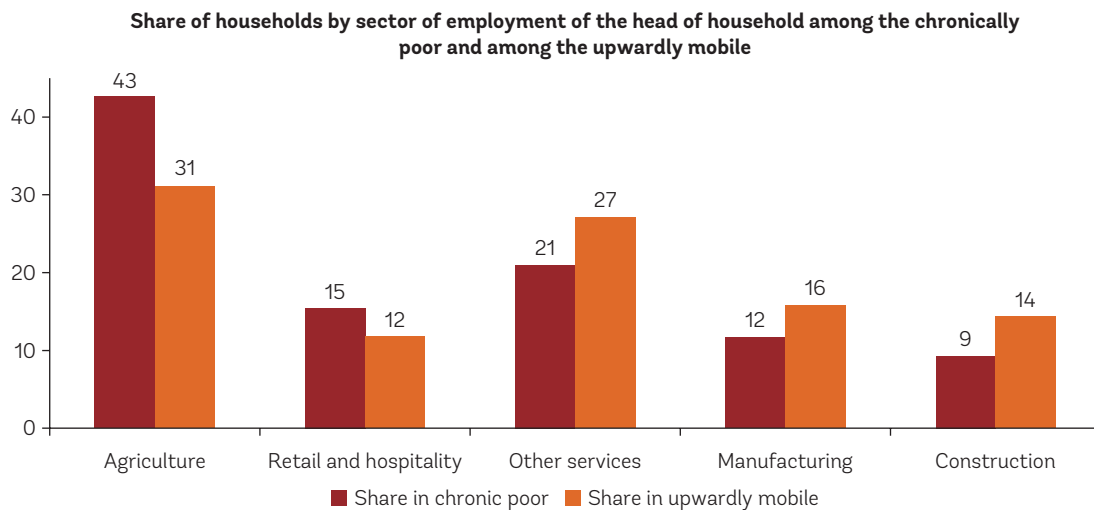
Sources: World Bank (Social Sector Expenditure and Institutional Review, forthcoming) and Central Bank of El Salvador.

among the chronically poor than among the upwardly mobile (see figure 3.8). The sectors which account for a significantly higher share among the upwardly mobile than among the chronic poor are construction and manufacturing. Unfortunately, as seen above, those two sectors have seen almost no job growth since 2002.

The role of transfers in boosting shared prosperity

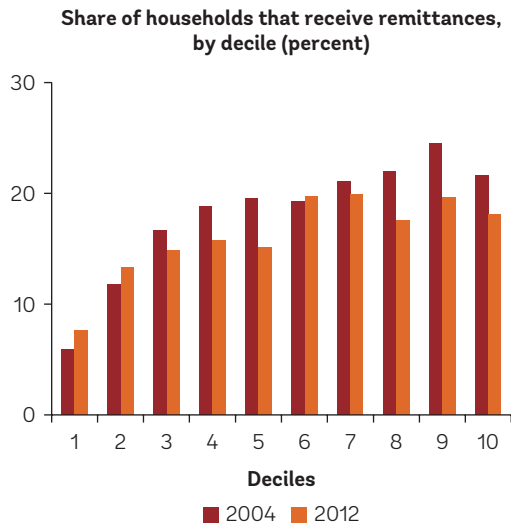
Remittances remain an important source of income for many households, including the bottom 40. As discussed above, after labor income, remittances are the second most important contributor to the reduction of poverty and inequality, with public transfers a distant third. An analysis of the incidence of remittances by income decile and over time, see figures 3.9–3.12 below, suggest the following stylized facts. First, remittances

FIGURE 3.8 Jobs in Retail and Hospitality and Agriculture Are Often Unable to Lift Workers from Being Chronically Poor



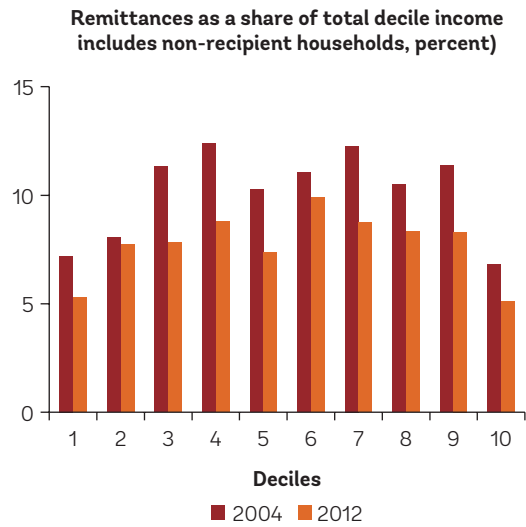
Source: World Bank staff calculations with data from SEDLAC (CEDLAS and The World Bank).

FIGURE 3.9 A Higher Share of Richer Households Receive Remittances



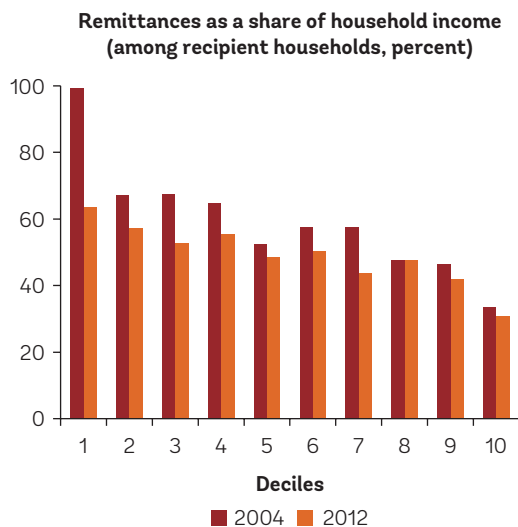
Source: World Bank staff calculations based on EHPM and US Bureau of Labor Statistics.

FIGURE 3.11 Remittances Are Important across the Entire Distribution of Income



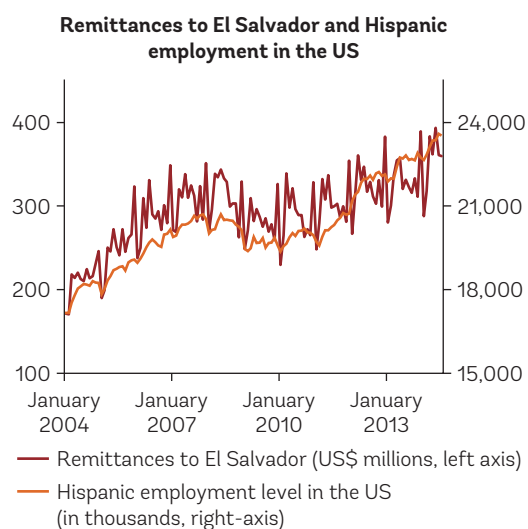
Source: World Bank staff calculations based on EHPM and US Bureau of Labor Statistics.

FIGURE 3.10 But Remittances Are a Greater Share of Income for Poorer Households



Source: World Bank staff calculations based on EHPM and US Bureau of Labor Statistics.

FIGURE 3.12 Remittances Respond to Labor Market Conditions in the US



Source: World Bank staff calculations based on EHPM and US Bureau of Labor Statistics.

remain in 2012 almost as important as they were in 2004 but somewhat less so. This decrease in the share of households that receive remittances helps to explain the relatively small effect that remittances had on poverty reduction as shown in figure 1.10 above. The share of households in the bottom 40 that receive remittances was approximately the same in 2004 and 2012 (13 percent). Second, for households in the bottom 40 that receive remittances they typically account for over half of total household income. Even for the top 60 percent of the income distribution, for households that receive remittances account typically between one-fifth of income (for the top decile) and half of the income (for the fifth decile). Third, as a share of total decile income remittances are most important for the middle deciles. This helps to explain why remittances contributed to a small

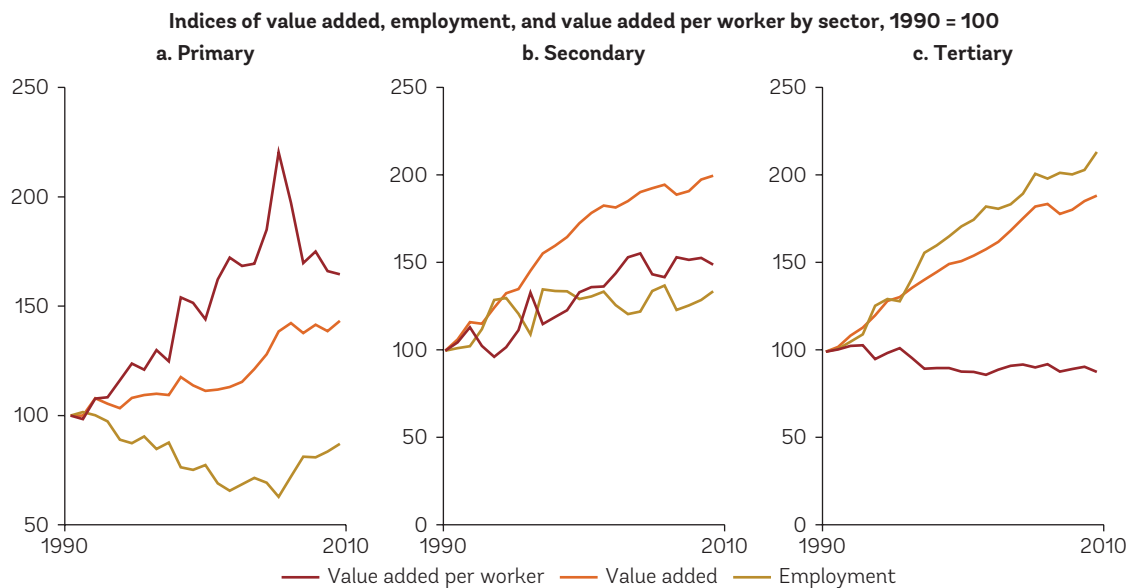
decrease in inequality. Finally, remittances are sensitive to labor market conditions in the US. As a result remittances are likely to be pro-cyclical and exacerbate the fluctuations in the business cycle.

What Are the Factors that Constrain Inclusion the Most?

Why is wage growth low?

Low wage growth is associated with stagnant labor productivity. Since 1990 the increase in employment in services has not been matched by the increase in value added (see figure 3.13). Thus, value added per worker has declined. This helps to explain why wages have remained stagnant. In the case of agriculture, employment was declining until around the

FIGURE 3.13 Employment Has Grown Most in Services but Value Added Lagged (Thus Labor Productivity in Services Has Declined)



Source: Central Bank of El Salvador.

time of the global economic crisis in 2008. As value added increased slightly this was a period of slight increases in labor productivity. Since 2008, however, employment has increased at a faster rate than value added, putting also pressure on the ability to pay higher wages in the sector. Only in manufacturing has labor productivity increased steadily over time, although employment in the sector has remained effectively flat.

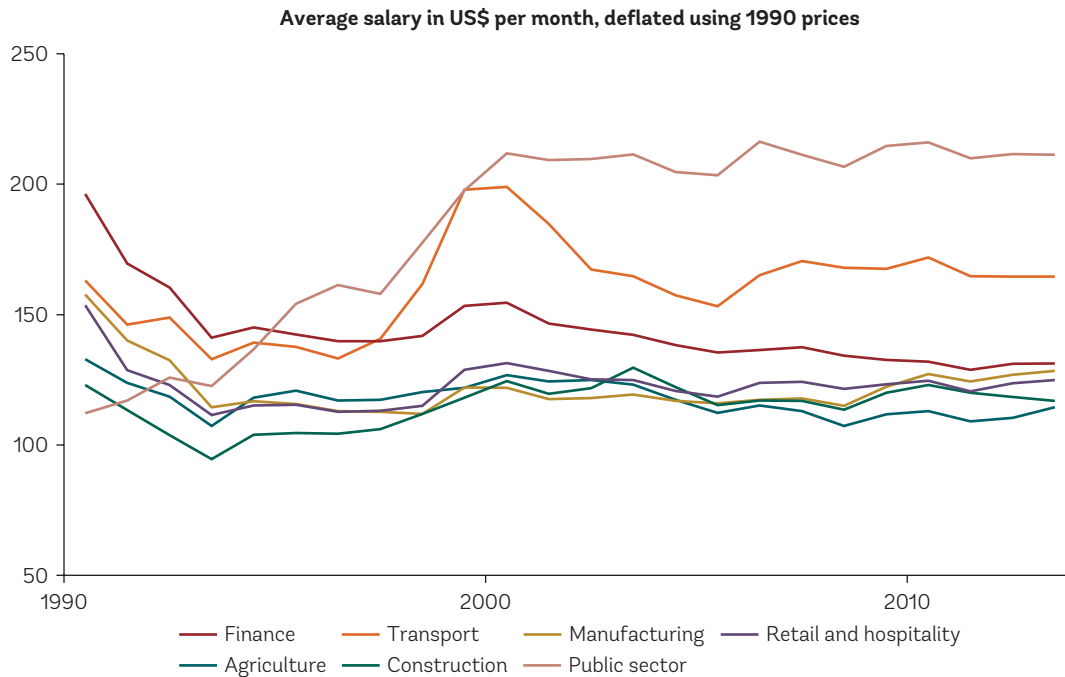
The majority of jobs created in El Salvador are characterized by low productivity. Many of the jobs created have taken place in services, where real output per worker declined. Real salaries have stagnated and unit labor costs have increased. In the case of jobs in the tradables sector, while productivity has increased, external competition has put

downward pressure on prices and constrained wage growth. As a result real wages have been stagnant across all sectors of the economy for a prolonged period of time (see figure 3.14 below).

Productivity growth is constrained by the low skill content of most jobs. An analysis of the skill content of the tasks undertaken by the labor force in El Salvador shows that there remains a gap compared with the skills structure of the US or other countries such as Costa Rica (Aedo and Walker 2012, 104). Compared to those countries El Salvador's labor force still performs tasks with a larger content of routine manual and non-routine manual physical skills.

Access to education has improved but the majority of workers still have limited schooling

FIGURE 3.14 Real Salaries Have Been Flat across the Economy for Over a Decade



Source: Cabrera (2014).

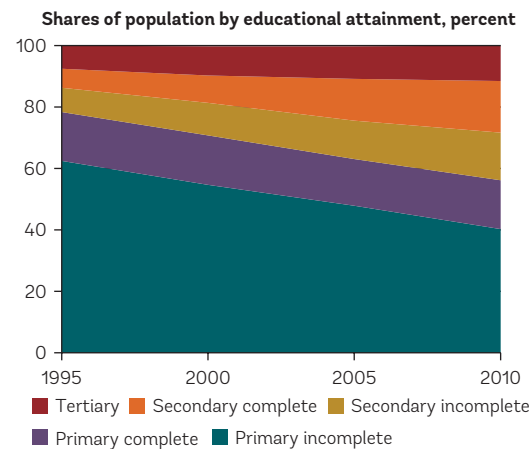
and few prospects of finding a well-paying formal job. El Salvador has made significant progress in raising the educational attainment of its population (see figure 3.15). However, it is still below the average for the region or the structural peers in indicators such as the average years of education. In addition, the proportion of the population with secondary education and tertiary education has not improved significantly. Only 38 percent of Salvadorans aged 18–24 have completed secondary education. Less than 60 percent of students complete sixth grade on time, one of the lowest completion rates in Latin America, and secondary school dropping out rates are very high, especially in rural areas. By age 14, one in five students in rural areas is no longer attending school (see figure 3.16 below).

There is a limited supply of human capital for innovation. The expansion of tertiary education has been slow. El Salvador has relatively few engineers (Lederman et al. 2014, 149). The inclination of students toward non-scientific studies may stem from a legacy of a traditional focus on humanities and

social science, making it difficult to switch quickly to other fields. Efforts to expand technology and English language studies could help support the development of business process outsourcing and software and digital content industries.

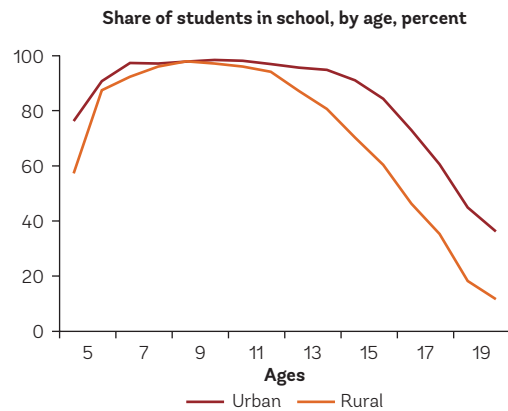
The quality of education is low, leading to learning outcomes below those achieved in other countries. Learning outcomes are far behind those in the best performing countries in the Latin American region (see further below). In fact, international standardized tests show Salvadoran students' scores below those of most countries (see figure 3.17).² These results may be partially explained by the low public spending on education. Even after increasing from 2.8 to 3.5 percent of GDP in 2007–12, public spending on education is still below the averages for Latin America and the Caribbean (LAC) and lower middle income countries (5.1 and 5.4 percent of GDP, respectively). Low efficiency of spending, which had also typically favored primary education, also explains the under-performance in learning outcomes. Teacher

FIGURE 3.15 School Attainment Has Improved



Source: World Bank.

FIGURE 3.16 The Majority of Students Still Drop Out of School Before Completing Secondary



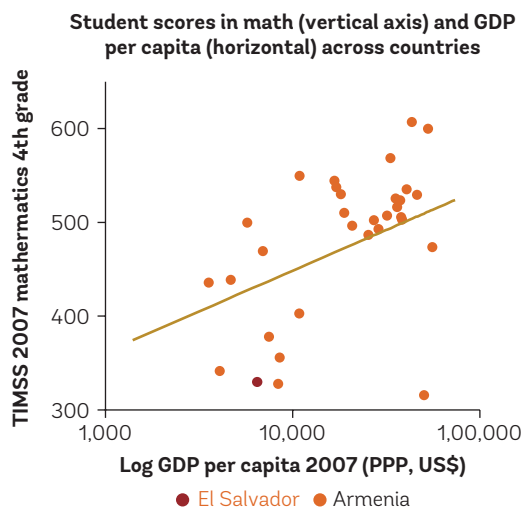
Source: World Bank.

quality is an additional factor. While 90 percent of teachers are university graduates only 10 percent of teachers tested achieved a high score in the TIMSS (World Bank 2012b).

In addition, informality is widespread and affects especially younger workers. The majority of jobs in El Salvador are characterized by low productivity, low remuneration,

and informality.³ In contrast with the trend of declining informality observed in other Latin American countries, informality in El Salvador is still on the rise.⁴ While open unemployment is low, at 5.9 percent in 2013, many workers have jobs in precarious conditions. Underemployment and precarious conditions affect particularly the young. For example the rate of formal employment for those under 25 years old is 13 percent (compared to 25 percent for those aged 25 to 49 years old).⁵ While the minimum wages increased by 4 percent in June 2013 and January 2014, they are not high compared to the region. In addition many employees either work part-time or receive salaries below the minimum wage. Overall, the minimum wage is in practice relevant for only around 25 percent of the labor force (Gindling, Oliva, and Triguero 2010, 61).

FIGURE 3.17 Poor Learning Outcomes



Source: TIMSS and World Bank.

How equitable is access to opportunities?

Uneven access to opportunities starts at a young age. A systematic way to capture the inequality of access to basic public services is the Human Opportunity Index (see

KNOWLEDGE GAP Why Is the Rate of Female Labor Force Participation Low?

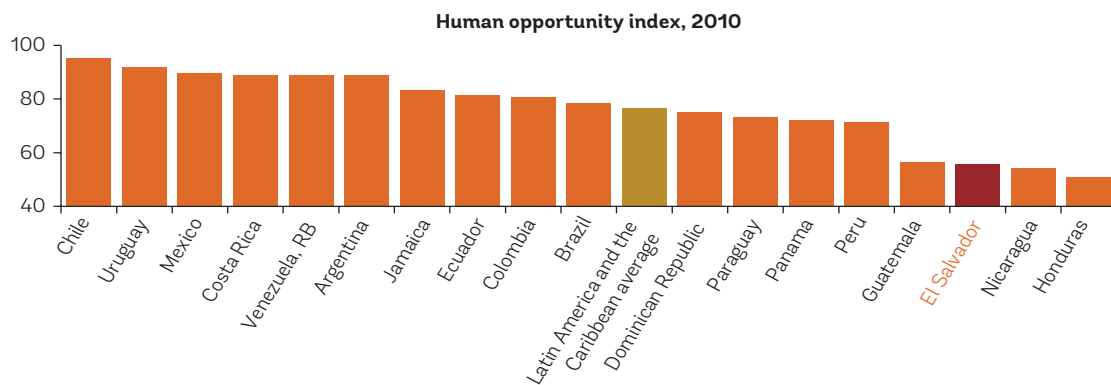
Female labor force participation is unusually low at around 47 percent, compared to around 80 percent for men. The female participation rate is especially low in rural areas where only 35 percent of women (as opposed to 87 percent of men) participate in the labor force. The impact of the female labor force participation rate is all the more important in El Salvador because, owing to a higher propensity to migrate among men, women account for a higher proportion of the population (the ratio of men to 100 women dropped from 98 in 1970 to 89 in 2010). Since labor is in most cases the main asset of the bottom 40, increasing the intensity of use could help boost shared prosperity.

figure 3.18). The Human Opportunity Index is an indicator that measures how a child's access to basic opportunities such as education, water, electricity and sanitation is affected by his or her circumstances—such as place of residence or education of the household head. The index shows that El Salvador ranks below most other countries in the LAC region for which the index is available. With lower access to basic public services, children may not be able to develop the skills required to become competitive adults in the labor force. Promoting more egalitarian access to basic goods and quality services early in life will likely both reduce inequality of outcomes in adulthood and increase economic efficiency, thereby strengthening the virtuous circle between growth and poverty reduction. This is particularly important because individual household characteristics other than income greatly affected social mobility in El Salvador from 1996 to 2011 (Cuesta, Ñopo, and Pizzolitto 2007; UNDP 2013). In this respect, it is important to note that access to opportunities has been improving over time.⁶

Inequities in access to education start early in life and increase with the age of children. A significant portion of poor family children do not attend pre-schools (only 38 percent in bottom quintile) and many enter late in first grade. Dropping out of school starts much earlier among the lowest quintile, around 10 years of age. By age 15 the gap in attendance between the lowest and highest quintiles is 20 percentage points. The inequities build up over time and by the time the students are of university age only 5 percent of those from households in the lowest quintile enroll in tertiary education.

Unequal education opportunities translate into worse learning outcomes among the bottom 40. El Salvador has achieved the Millennium Development Goal (MDG) of universal primary education, but the enrollment rates for other levels of education and the quality of the learning across the board are still low. The gross enrollment rate in upper secondary education in 2011 was 46 percent, the lowest in Central America. Inequities in the quality of education lead to worse learning outcomes for the bottom 40.

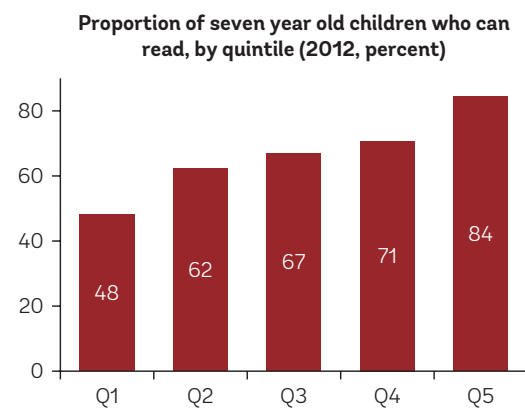
FIGURE 3.18 Access to Opportunities Is More Unequal than in Other Countries in LAC



Source: Molinas et al. 2010.

The proportion of 7 year olds who can read varies greatly by quintile. Only 55 percent of children from the bottom 40 percent can read while 73 percent of those in the top 60 percent can (see figure 3.19). The difference is larger if one compares the lowest quintile (48 percent of 7 year olds can read) with the highest quintile (84 percent can read).

FIGURE 3.19 Inequities in Learning Outcomes Start Early in Life

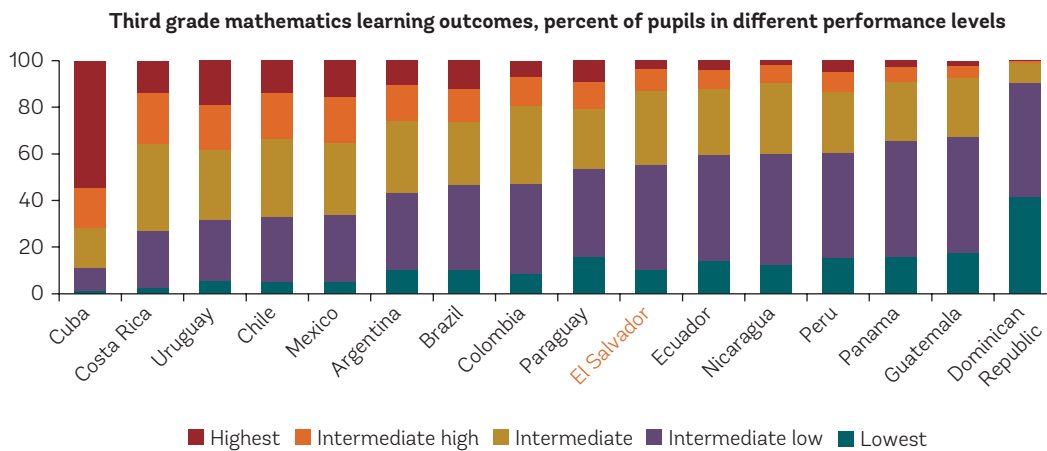


Source: World Bank 2015a.

Public spending on education in El Salvador has been steadily growing but remains relatively low. In 2012 public spending on education reached 3.5 percent of GDP, which is lower than the average for the LAC (4.9 percent) and the (OECD) (5.6 percent). A disproportionately high share of public spending in education (61 percent) still goes to basic education.

The increase in public spending on education has not translated into improvements in learning outcomes (see also figure 3.20 for a comparison with other countries on learning outcomes in mathematics). Differences in learning outcomes are greater between rural and urban areas than between boys and girls. For example, results from UNESCO’s Second Regional Comparative and Explanatory (SERCE) study for Latin America indicate that the percentage of pupils below the lowest performance benchmark in third-grade math was much higher in rural than urban areas (14 and 6 percent, respectively) while it was similar for girls and boys nationwide (11 and

FIGURE 3.20 Learning Outcomes in Mathematics Are Average among Countries in LAC



Source: SERCE.

10 percent, respectively). The concentration of training opportunities in the capital and among large employers is another source of inequity (USAID 2008).

There is a relatively large number of youth that neither studies nor works (the so-called *ninis*). The share of 15–18 year olds that are neither in school nor working is 16 percent. It is also particularly noteworthy that there are three times more women than men who neither study nor work. Since labor is in most cases the main asset of the bottom 40, increasing the intensity of use could help boost shared prosperity. What drives the decision to drop out and remain outside of

the labor force is a question insufficiently studied and understood. The phenomenon of *ninis* contributes to the intergenerational persistence of inequality and has a strong gender dimension as two out of every three *ninis* across Latin America are women (see also box 3.1).

The phenomenon of the *ninis* affects mainly the bottom 40. It is estimated that nearly 60 percent of *ninis* in Latin America are from a household in the bottom 40 percent (De Hoyos, Rogers, and Szekely 2015). The *nini* phenomenon is also linked to crime (Chioda 2015). These links create additional risks for youth and the society as a whole.

BOX 3.1 Uneven Progress Toward Gender Equality—With Self-Reinforcing Dynamics

El Salvador has made important efforts to recognize and advance the rights of women by signing and ratifying major international treaties and passing several important pieces of domestic legislation. However improvements in the legal framework have not fully translated into comparable progress in gender equality of endowments, such as health, education, economic opportunities, family dynamics voice and agency. Many of these factors entail mutually-reinforcing dynamics, for example, with interactions between dropping out of school, teenage pregnancy, female labor force participation, economic dependence on remittances from absent male partners and fathers who have migrated, and differentiated impacts of crime and violence.

Reproductive health and teenage pregnancy: El Salvador has made progress on all of the reproductive health indicators over the last decade. Maternal mortality has decreased, the share of women receiving prenatal care increased, and the prevalence of contraceptive use grew. These improvements, however, have not been equally enjoyed throughout the country as socioeconomic characteristics, including poverty, education, and location greatly impact health indicators. Abortion is illegal under any circumstances, which has prompted the UN’s Committee on the Elimination of Discrimination against Women to call for a national dialogue on the consequences of that restrictive legal framework in 2008. Similar concerns have been reiterated more recently by the UN’s Committee on Economic, Social and Cultural Rights in 2014. Adolescent fertility, an important proxy

box continues next page

BOX 3.1 continued

indicator for women's agency, has decreased from 100 to 76 births per 1,000 women aged 15 to 19 between 2000 and 2012, but remains high among rural and less educated teens (see also World Bank 2012e). UNFPA reports that 32 percent of prenatal inscriptions in El Salvador in 2013 were for women under the age of 19, and two percent of these were for very young girls, ages 10–14.

Education—and the *ninis*: Secondary school dropout is high overall for El Salvador (only 40 percent of Salvadorans ages 25 to 20 have completed high school). Gender differences for school exit are small overall, but drop-out rates are higher for girls in upper secondary school. The self-claimed reasons for dropping out are different, with girls more likely to declare “lack of interest” or “personal reason” for not being in school (possibly related to household duties) and boys more likely to leave school for “economic reasons.” Moreover, what teen boys and girls do after leaving school differs significantly. Gender norms that affect young men and women's roles within the family and society are likely to impact individual decisions to continue or to leave school. Among the youth aged 15 to 24, women are more likely than men to be neither studying nor working: 35 percent of women vs. 10 percent of men in that age group are so-called *ninis*, short for *ni trabajan, ni estudian*. Female *ninis* often mention the need to do household work as a predominant reason to drop out of school and 45 percent of them are either married or living with a partner, compared to 10 percent of male *ninis*.

Labor force participation and economic opportunity: Female labor force participation lags behind regional averages and, as identified in the main text above, the factors contributing to this low female labor force participation constitute a knowledge gap. However, female unemployment rate is lower than the regional average and the male unemployment rate. Women in El Salvador are also less likely than men to have an informal job. In addition, the gender wage gap is among the lowest in the region: in 2010 women received on average 87 percent of men's remuneration. The combination of low participation rates and relatively good indicators of the quality of labor force participation suggests the existence of some barriers to entering labor force, which discourage the less qualified. Gender norms may constitute one such barrier. However, this hypothesis needs further investigation.

Migration, dependency, parental absence, and family dynamics: Males are significantly more likely to migrate than females, and females in households that receive remittances have lower labor force participation rates. Micro-econometric evidence has uncovered that remittances reduce labor force participation for women at all ages, with a higher negative impact at younger ages, presumably allowing maternity options or home-based activities (Acosta 2006). However, this can put young women in a situation of being dependent on income support from remittances of male partners living abroad. It also raises

BOX 3.1 continued

the issue of parental absence—particularly for fathers. About one third (35 percent) of all minor children in El Salvador are being raised in households with a single parent (or none). A quarter (24 percent) of children are being raised by a single mother. Fathers account for 93 percent of “absent parents” (and this figure has remained stable over the years from 2010–13).

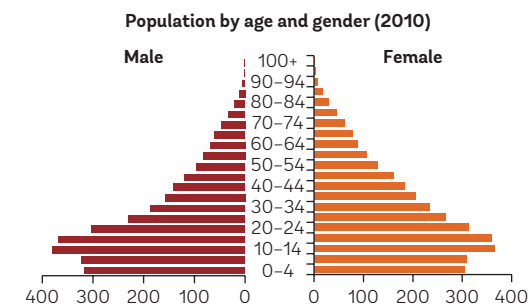
Crime and violence: Young men are much more likely to be victims of homicide, while women are much more likely to suffer violence in private and at the hands of those they know. Household survey data suggests that women are more likely to report physical or sexual partner violence in El Salvador than elsewhere in LAC; 36 percent of women ever married or in union (age 15–49) sought institutional help, and 65.5 percent told family and friends.

Political participation, voice and agency: In national-level politics female participation grew significantly after a national political party reform establishing a 30 percent quota of women on electoral ballots. In 2013, with 26 percent female representation in parliament, El Salvador exceeds the LAC average. Gains in municipal-level representation remain small, with women making up only ten percent of Salvadoran mayors.

In addition, the problem of the *ninis* in El Salvador could keep the country from exploiting the demographic dividend that is the result of a bulge in the population pyramid (see figure 3.21).

The bottom 40 faces lower returns to education than those individuals who come from a higher socio-economic background, which has implications for policy design. An individual’s earnings are closely linked to the socio-economic background of the family in which she grew up. Those who grew up in families where the head of household only had primary education will see their salary increase if they achieve secondary and tertiary education. But the increase in salary from educating herself will likely be much smaller than the increase from achieving the same education level for someone who grew

FIGURE 3.21 The Potential for a Demographic Dividend



Source: UNFPA.

up in a family where the head of household had a tertiary education. The difference is in fact two and a half times higher on average (World Bank 2012b, 13). This gap is due to a variety of factors, including the greater

KNOWLEDGE GAP Why Do So Many Students Drop Out of School?

The majority of Salvadoran students drop out before completing high-school. Without educated and skilled workers it will be challenging for El Salvador to create enough good jobs. Understanding what drives the decision to drop out is an important input for designing policies to address the situation.

A number of factors may be behind the phenomenon of dropping out of school. First, remaining at school has an opportunity cost for households. In fact, in the poorest quintile of the income distribution 15–18 year olds contribute an average of 8 percent of total household income. There are also social factors, like migration, crime, and teenage pregnancies, that likely affect the decision to stay in school. When asked directly about why they dropped out, Salvadoran youth's most frequent answers are “lack of interest” (34 percent), “need or want to work” (19 percent), “cannot afford to continue” (18 percent), and “household responsibilities” (17 percent) (World Bank 2015a). There may also be supply constraints, including lack of schools and/or seats particularly in rural areas; fees and other costs at the secondary level may present barriers to continuing. In addition, the overall poor quality at primary level may undermine performance of students at secondary levels and motivation to stay in school.

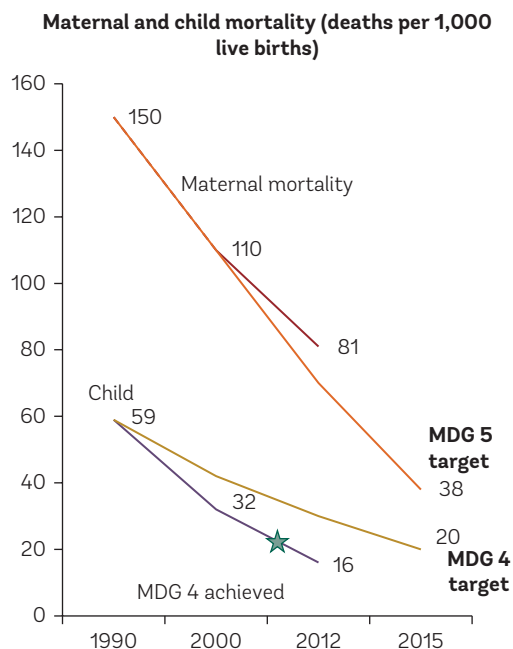
non-cognitive skills among those who grew up with more educated parents as well as the value of social networks which make it easier to find a good paying job (World Bank 2012b, 13). The evidence of differential returns to education for the bottom 40 percent calls for nuanced and behaviorally-informed policies that could help address these complex challenges.

While there has been substantial progress in access to health care some inequities persist. El Salvador has made substantial progress in health, including meeting the under-five mortality rate goal under the MDGs (see figure 3.22 below). In addition the bottom 40 are increasingly making use of public healthcare facilities. However, although utilization has increased, 42 percent of sick people from the first two quintiles do

not seek care (down from 52 percent in 2008). Public spending on health has increased from 3.4 to 3.8 percent of GDP in the period 2007–12. However, there are significant inequalities in the system: different per capita spending and service packages across institutions Public spending per capita is more than twice as high among the institutions that serve those covered by the social security (1.4 million beneficiaries) compared to those that cover the rest of the population (4.7 million).

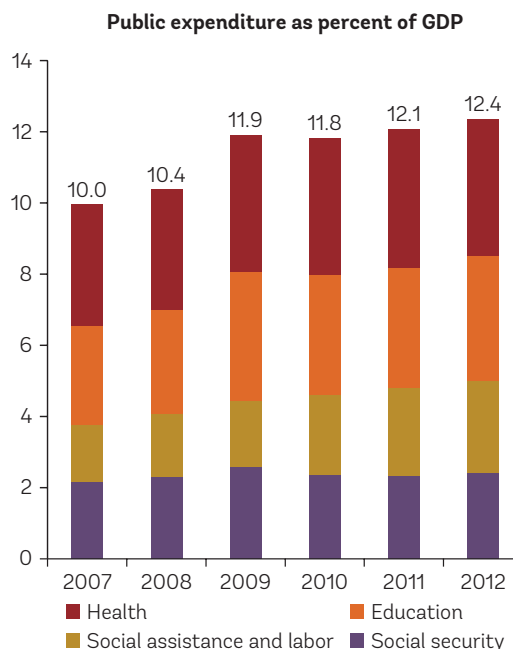
Some health risk factors are particularly prominent among the bottom 40. Among the health risk factors that are different for the bottom 40 are those related to indoor air pollution from burning wood for cooking. Exposure to indoor air pollution increases the risk of pneumonia and other acute lower

FIGURE 3.22 Under 5 Mortality MDG Achieved



Source: World Bank 2015a.
Note: MDG = millennium development goal.

FIGURE 3.23 Public Spending in Social Sectors Has Increased



Source: World Bank 2015a.

respiratory infections in young children and lung cancer in adults. Among the bottom 40 percent the use of firewood as a cooking fuel is common in around 40 percent of households. The issue is particularly important in rural areas, where 67 percent of households burn wood.²

A challenge faced by the health is to ensure that improvements in access to health services translate in improvements in quality. Although institutional deliveries increased, maternal mortality did not decrease accordingly (see figure 3.22). In addition, epidemiological changes in the country profile need to be reflected in the health system. This implies, for example, the inclusion of management of chronic conditions in primary health care strategy.

Public spending in social programs has increased significantly in the last years. Social sector spending increased from 10 percent of GDP in 2007 to 12.4 percent of GDP in 2012. As of the latter year, social protection and labor (including social security and subsidies) accounted for the largest portion of social spending, 5 percent of GDP, followed by health (3.8 percent), and education (3.5 percent) (see figure 3.23 above). In real terms, overall social spending per capita increased at an annual average rate of 3.2 percent from 2007 to 2012.

But spending in social programs is insufficiently targeted. While public expenditure on social programs has increased in recent years, it remains poorly targeted with the bulk of expenditure being accounted for by the gas and electricity subsidies. Those

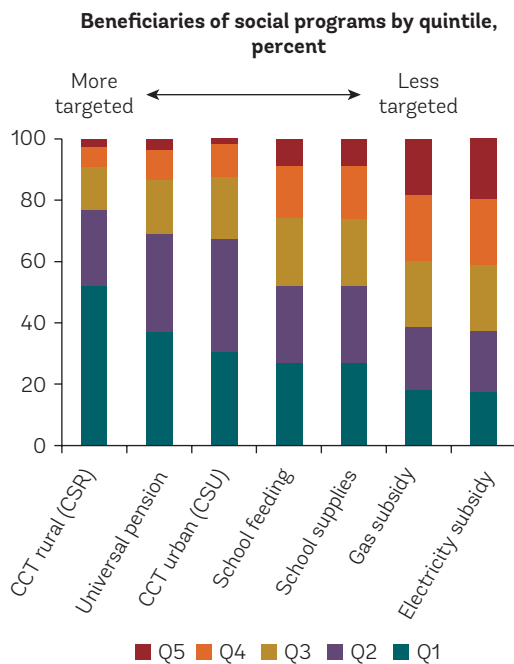
subsidies have much less of a pro-poor focus as they benefit almost all quintiles equally (see figure 3.24 below). Expenditure, however, is concentrated on those programs that are less targeted (see figure 3.25 below). As a result the bottom 40 percent of the income distribution benefits from only 0.8 percent of GDP across all social sector programs while the top 60 percent benefits from 1.2 percent of GDP in social assistance when all programs are considered.

There are also specific challenges of connectivity in the more isolated rural areas. An analysis of the movement of goods and people between municipalities shows that the less connected municipalities typically overlap with those with highest levels of poverty

(see appendix, Amaya and Cabrera 2012, 2013).

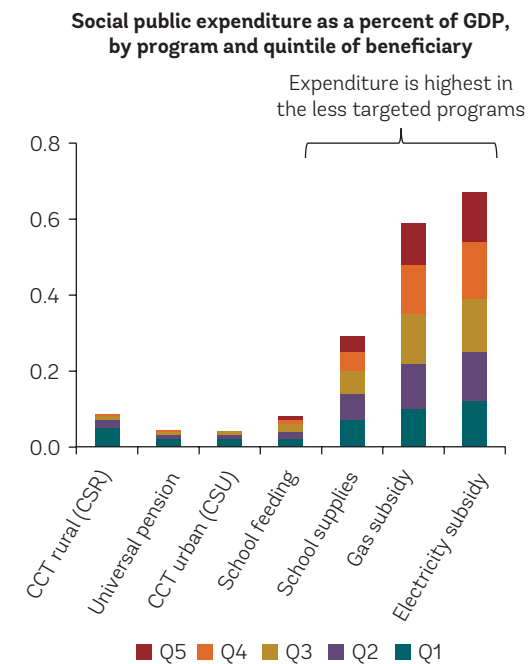
High costs of services such as broadband put the bottom 40 at a disadvantage to exploit the benefits of information and communications technology. For the lowest quintile the cost of broadband would be equivalent to 19 percent of their income. Only 10 percent of schools are connected to the internet. Fixed broadband only reaches about one third of municipalities. Limited competition between telecommunications operators that control access to the four submarine cables and charge relatively high prices to wholesalers (who then transfer the high prices to retail customers) may be a factor driving the high prices.

FIGURE 3.24 Some Social Programs Are More Targeted than Others



Source: World Bank 2015a.

FIGURE 3.25 Spending in Social Programs Is Concentrated in the Less Targeted Ones

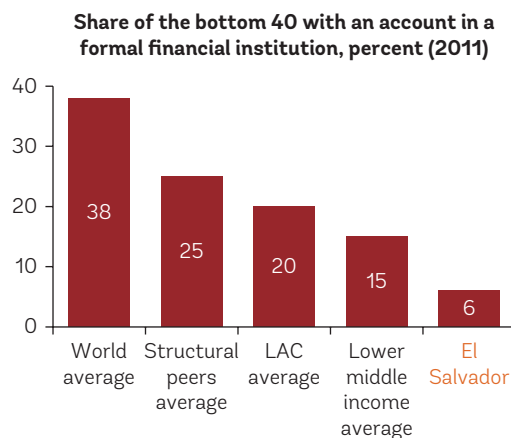


Source: World Bank 2015a.

Financial inclusion of the bottom 40 is a major challenge. The vast majority of the population reporting that they do not use formal financial services. Although remittances service providers are widely used in El Salvador, regular use of accounts at financial institutions is much more limited. There are 10 commercial bank branches per 100,000 adults, which is below the level in neighboring countries such as Costa Rica (23), Honduras (23). Most provision of financial services takes place in San Salvador, where regulated financial institutions have about half of their branch and ATM presence. Only 14 percent of the Salvadoran population has an account at a formal financial institution, well below the Latin American average of 39 percent and just 6 percent of the bottom 40 had an account in a formal financial institution, a figure which is much lower than any of the comparator sets (see figure 3.26). There are also differences in gender and geographic area in the proportion of those having an account: 10 and 18 percent for females and males respectively, and 11 and 18 percent for rural and urban respectively.

These gaps in access to finance are not being narrowed, as the financial sector is growing slowly. El Salvador's financial system has been growing more slowly than the regional average. At 44 percent in 2013, private sector credit to GDP is below its expected value, based on predictions given its income and indicators of its level of development. It also lags relative to regional averages for Central America and LAC. Growth rates for credit to the private sector are the lowest in Central America. Deposit growth rates are also low. Similar to other countries in Central America, the securities markets of El Salvador is limited in size and importance as

FIGURE 3.26 Financial Inclusion Is Low



Source: Global Financial Inclusion Database.

a source of funding for corporates. Insurance market premiums are 2.1 percent of GDP.

Identifying Policy Areas to Boost Inclusion

BASED ON THE ABOVE ANALYSIS the following policy areas emerge as critical to boost inclusion:

Improving education, which by increase opportunities will help address the vicious circles from low opportunities to violence and migration. The bottom 40 is particularly affected by poor learning outcomes. Inequities start early in life—as noted above, only 55 percent of children from the bottom 40 percent can read. Low quality of education is also likely one of the contributing factors to the high school drop-out rate, which limits the use of opportunities at home and abroad. Improving education will help address the lack of quality employment opportunities that is driven by the expansion of the non-traded sector creates low productivity

jobs. Among the institutional challenges faced by the education sector include scaling up full-time school model that started as a pilot in primary schools in selected municipalities. More broadly, the school-based management system has been disproportionately focused on monitoring financial resources, and very little on quality standards.

Addressing gaps in access to finance and to quality basic services, which will help address the vicious circle of low savings and investment and low growth. As noted above, El Salvador ranks among the countries in LAC with a low Human Opportunity Index. In addition to improving education, there is a broader agenda in improving access of the bottom 40 to basic opportunities, including water and sanitation and healthcare. The bottom 40 are also considerably under-banked. Greater financial inclusion can also help increase savings out of the large remittance flows that many Salvadoran households receive.

Improving the targeting of the social protection system. Currently public social expenditure is concentrated on those programs that are less targeted. As a result the bottom 40 percent of the income distribution

benefits from only 0.8 percent of GDP across all social sector programs while the top 60 percent benefits from 1.2 percent of GDP in social assistance across when all programs are considered. Improving the targeting of social expenditures can help to make the state's action more visible to citizens. In fact, despite the very wide coverage of subsidies like electricity, transport, gas, or water, when asked in the LAPOP 2012 survey if they received assistance from the government only 10.5 percent of Salvadorans responded affirmatively. At the same time Salvadorans appear to have an attitude of openness to efforts of the government to reduce inequalities. For example, on a 0–100 scale, Salvadorans average 83 on the opinion, as expressed in the same LAPOP 2012 survey, that the government should implement policies to reduce income inequality. This locates El Salvador as one of the countries in LAC where government intervention to promote equality is most favored. Above all, increasing the targeting of social expenditures could result in savings that could be redeployed to address the needs for improved access to basic services identified above.

Notes

1. As a result the contribution of structural change to labor productivity growth became negative in the period 2005–09 (Amaya and Cabrera 2013, 17), a result which is also found in other countries in Latin America (McMillan and Rodrik 2011).
2. TIMSS scores for girls and boys in fourth-grade math were relatively similar (325 and 334 respectively).
3. While informality is widespread it is also worth noting that comparable evidence suggests that informality in El Salvador as measured by either the legal or productive definitions is lower than the average for Latin America and the Caribbean region (Perry et al. 2007, 29).
4. El Salvador is, one of only two out of nine countries for which data is available where informality has increased in recent years (see World Bank 2012d, 56). In addition the share of workers employed in large firms declined, again in contrast with the experience of other Latin American countries.
5. For an analysis of the labor market see World Bank, “Better Jobs in Central America: The Role of Human Capital” (2012a) and its

companion “Mejores empleos en El Salvador: El rol del capital humano.” On youth see World Bank, “Youth Development and Economic Opportunities in El Salvador” (2010).

6. The Human Opportunity Index improved since 1995 and there is also evidence that intergenerational mobility in educational

attainment increased from 1995 to 2009 (Ferreira et al. 2013, 8).

7. The issue of using wood as fuel for cooking also has an environmental sustainability implication since it is estimated that only 42 percent of the wood is collected in a sustainable way (Wang et al. 2013).

4. Sustainability Challenges

Economic Sustainability

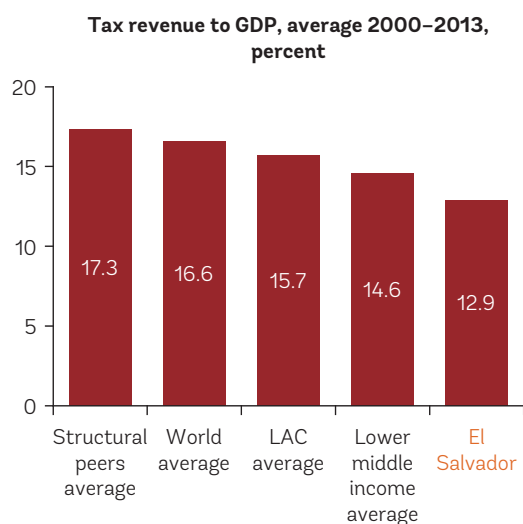
RIISING TO THE DEVELOPMENT CHALLENGES identified is made difficult by the lack of state capacity and fiscal space. The lack of confidence in public institutions is in part a reflection of a relatively ineffective state.¹ Weak state capacity is both a function of limited public revenues and manifests itself in the difficulty of raising revenue, especially from direct taxes.² Resources available to the Salvadoran state have been comparatively low (see figure 4.1). Tax revenues throughout the 1990s averaged 10 percent of Gross Domestic Product (GDP) and only reached 12 percent of GDP in 2005. Since then, and despite the impact of the global economic crisis, tax revenues have increased to around 15 percent of GDP in 2013. Despite tax efforts over the last five years, fiscal deficit has increased

and averaged 4 percent of GDP over the last three years. El Salvador has raised tax revenue from 13.8 percent of GDP in 2003 to 15.8 of GDP in 2014.³

Increased spending has outpaced efforts to increase revenues. Limited public revenues has traditionally constrained public investment, which has averaged less than 3 percent of GDP (among the lowest in the world see appendix) and social spending. Since 2008 there has been an increase in social spending which has brought El Salvador closer to, although still below, the rates of social spending that are common in the rest of Latin America (World Bank 2015a). Social sector spending increased by around two percentage points from 10.4 to 12.4 percent of GDP between 2008 and 2012. This fully accounts for the increase in overall public expenditures since 2008.⁴ As this increased spending has outpaced the rise in revenues, the resulting deficits have led to higher fiscal deficits, averaging 4 percent of GDP over the last three years, and an increase in public debt (including pensions) from around 40 percent of GDP in 2008 to around 58 percent of GDP in 2013 (see figure 4.2 and tables 4.1 and 4.2). Due to the fiscal imbalances since the crisis the fiscal position of El Salvador today compares unfavorably with comparator countries (see figure 4.3).

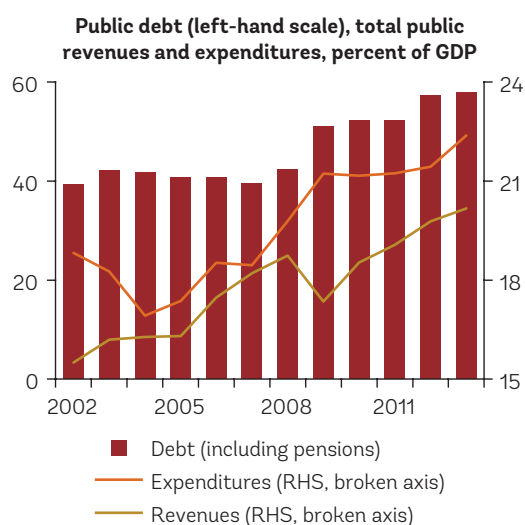
While there are no immediate risks to debt sustainability, the increase in public debt since the 2008 global economic crisis will require measures to keep it in check. A debt sustainability analysis suggests that if current spending and growth trends were to continue public debt would increase to around 70 percent of GDP by 2019.⁵ Estimates of the needed fiscal

FIGURE 4.1 A Small State



Source: World Bank.

FIGURE 4.2 Rising Public Debt



Source: Central Bank of El Salvador.

adjustment point to between 1.5 and 3.5 percentage points of GDP depending on whether debt is to be stabilized at slightly higher levels than now or brought back to around 50 percent of GDP (IMF 2015a). In terms of financing risks there are expected to be peaks in financing needs in 2019 due to previously issued bonds maturing. In addition, interest rate risk is a factor to take into account, especially in light of the expected normalization of U.S. monetary policy interest rates over the medium term. Interest payments today stand at around 2.4 percent of GDP (with a public debt of 58 percent of GDP).

The current pension system, which covers only one in ten people among the bottom 40, substantially adds to fiscal pressures. Social security covers still a small portion of the population, without improvement in recent years. As of 2013 around 30 percent of workers were contributing to the social security and only 20 percent of the elderly received a pension (including 5 percent that received a

non-contributory social pension). These figures do not represent a significant change compared to 2007, when 31 percent of the population was covered by social security. While the pension system benefits only a small minority of the population it incurs a deficit on the fiscal accounts of close to 2 percent of GDP, around half of the overall fiscal deficit. As of 2013 the stock of these pension liabilities accounted for around 11 percent of GDP—it is important, however, to stress that the pension liabilities are automatically invested in government paper. In addition, some of the parameters of the system are relatively generous, including a retirement age of 55 years old. Given these considerations there is a wide recognition in the country on the need to reform the pension system to increase its sustainability and equity.

Higher economic growth will be critical to reduce fiscal risks. El Salvador's fiscal situation has been aggravated by the sub-par growth performance. Importantly, the low growth has been in line with potential output growth, which most recent estimates put at only 2 percent (IMF 2015b). Increasing potential economic growth would therefore be critical not only to boost the income of the bottom 40 but also to safeguard sustainability.

The banking sector, which dominates the Salvadoran financial system, presents strong financial indicators, but its lending remains limited. Foreign owned banks dominate the financial system and the concentration of bank assets remains relatively high, with the largest 3 banks owning 95 percent of assets in 2012. There is also financial intermediation taking place through the many unregulated cooperatives and savings and loans associations, which are not captured in official statistics. The capital adequacy ratio for the system stands at 17.4 percent (above the

TABLE 4.1 Selected Economic Indicators, 2008–13

	2008	2009	2010	2011	2012	2013
<i>Production and prices</i>						
Nominal GDP (US\$ billion)	21.4	20.7	21.4	23.1	23.8	24.3
Real GDP growth (%)	1.3	-3.1	1.4	2.2	1.9	1.7
Inflation rate (CPI)	5.5	0.1	2.1	5.1	0.8	0.8
Gross domestic investment (% of GDP)	15	13	13	14	14	15
Public sector	2	2	2	2	3	3
Private sector	13	11	11	12	12	13
Gross national savings (% of GDP)	8	12	11	9	9	9
Public sector	0	-3	-2	-2	-1	-1
Private sector	8	15	13	11	10	10
<i>External sector</i>						
Current account (% of GDP)	-7.1	-1.5	-2.5	-4.8	-5.4	-6.5
Merchandise trade balance	-21.9	-15.0	-16.5	-18.4	-18.8	-19.6
Services	-1.0	-0.4	-0.4	-0.3	0.2	0.3
Primary income	-1.8	-2.7	-2.5	-2.8	-3.7	-4.0
Remittances	17.5	16.7	16.8	16.6	16.9	16.9
Terms of trade (% change)	-9.5	12.6	-5.6	-2.5	0.5	-1.6
FDI (net) (% of GDP)	4.2	1.8	-1.1	0.9	2.0	0.6
<i>Public Sector</i>						
Revenues and grants (% of GDP)	17.4	16.4	17.8	18.2	18.9	19.3
Current revenues, o/w:	17.2	15.9	17.0	17.3	18.2	19.0
Tax revenues	13.5	12.6	13.5	13.8	14.4	15.4
Non tax revenues	2.9	2.8	3.0	2.8	3.1	3.1
Others	0.8	0.5	0.5	0.7	0.7	0.5
Spending and net lending (% of GDP)	20.6	22.1	22.0	22.2	22.8	23.4
Current spending, o/w	17.5	19.0	18.9	19.3	19.4	20.2
Wages and salaries	7.1	8.0	8.0	8.3	8.4	8.7
Goods and services	3.8	4.2	4.4	4.0	3.9	4.4
Interests	2.4	2.6	2.4	2.2	2.3	2.4
Current transfers	4.1	4.2	4.1	4.7	4.7	4.6
Capital spending	3.1	3.1	3.2	2.9	3.4	3.2
Primary balance (% of GDP)	-0.8	-3.1	-1.9	-1.7	-1.6	-1.6
Overall fiscal balance (incl. pensions, % of GDP)	-3.2	-5.7	-4.3	-3.9	-3.9	-4.1
Total public debt (% of GDP)	45.4	51.0	52.2	52.2	57.3	57.8

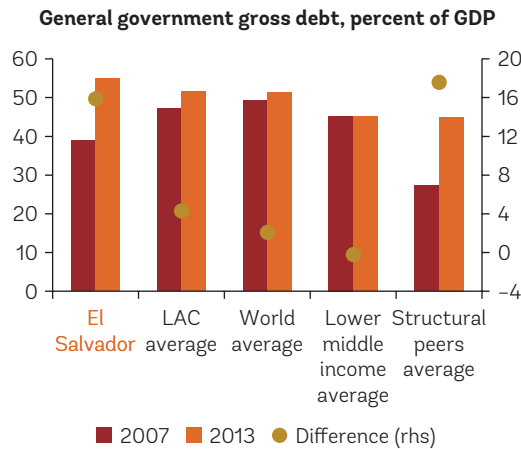
Source: World Bank staff estimates for 2014 and forecasts for 2015–19. Historical data from the Central Bank of El Salvador.

TABLE 4.2 Selected Economic Indicators and Forecasts, 2014–19

	2014	2015	2016	2017	2018	2019
<i>Production and prices</i>						
Nominal GDP (US\$ billion)	25.0	26.2	27.3	28.6	29.7	30.9
Real GDP growth (%)	2.0	2.2	2.4	2.6	2.3	2.0
Inflation rate (CPI)	2.0	2.0	2.0	2.0	2.0	2.0
Gross domestic investment (% of GDP)	15	15	15	16	15	15
Public sector	2	3	3	3	3	3
Private sector	12	12	13	13	12	12
Gross national savings (% of GDP)	9	10	10	9	9	8
Public sector	-1	-1	-2	-2	-2	-3
Private sector	11	11	11	11	11	11
<i>External sector</i>						
Current account (% of GDP)	-5.5	-4.9	-5.6	-6.5	-6.3	-6.2
Merchandise trade balance	-19.4	-18.7	-19.4	-20.1	-19.8	-19.5
Services	0.8	0.8	0.8	0.8	0.8	0.8
Primary income	-4.4	-4.4	-4.4	-4.5	-4.5	-4.7
Remittances	17.5	17.5	17.4	17.3	17.3	17.2
Terms of trade (% change)	2.1	1.9	0.2	0.1	0.0	0.5
FDI (net) (% of GDP)	0.5	1.7	1.8	2.1	1.9	1.9
<i>Public Sector</i>						
Revenues and grants (% of GDP)	19.0	19.0	19.4	19.5	19.5	19.4
Current revenues, o/w:	18.8	18.8	19.0	19.1	19.2	19.2
Tax revenues	15.2	15.2	15.4	15.6	15.6	15.6
Non tax revenues	3.1	3.1	3.1	3.1	3.1	3.1
Others	0.5	0.5	0.5	0.4	0.5	0.5
Spending and net lending (% of GDP)	23.0	23.4	24.0	24.3	24.6	24.9
Current spending, o/w	20.0	20.2	20.8	20.9	21.2	21.7
Wages and salaries	8.9	9.1	9.1	9.1	9.1	9.1
Goods and services	4.2	4.1	4.1	4.1	4.1	4.1
Interests	2.5	2.7	3.0	3.2	3.5	3.9
Current transfers	4.4	4.3	4.3	3.4	4.5	4.6
Capital spending	3.0	3.2	3.4	3.4	3.4	3.2
Primary balance (% of GDP)	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Overall fiscal balance (incl. pensions, % of GDP)	-4.0	-4.4	-4.6	-4.8	-5.1	-5.5
Total public debt (% of GDP)	60.0	61.9	63.9	65.9	68.5	71.4

Source: World Bank staff estimates for 2014 and forecasts for 2015–19. Historical data from the Central Bank of El Salvador.

FIGURE 4.3 Fiscal Position Compares Unfavorably with Other Countries



Source: IMF.

statutory requirement of 12 percent) as of June 2013 while liquid assets cover about 33.5 percent of deposits. Non-performing Loans (NPLs) declined from 3.4 percent in 2012 to 2.7 percent in June 2013, after increasing sharply in 2009. Since 2009, profitability has been positive and improving--the return on average assets (ROA) reached 1.7 percent, and return on equity (ROE) was 13 percent as of June 2013. Net interest margins (spreads) are in line with Latin America averages. However, capitalization and liquidity ratios are preserved by low credit intermediation. A strong financial sector is critical given the country's dollarization.

Environmental Sustainability

THE IMPACT OF NATURAL DISASTERS results in average annual losses of around 2.5 percent of GDP, posing a threat to the sustainability of improvements in development. These losses add to fiscal pressures and constrain wealth

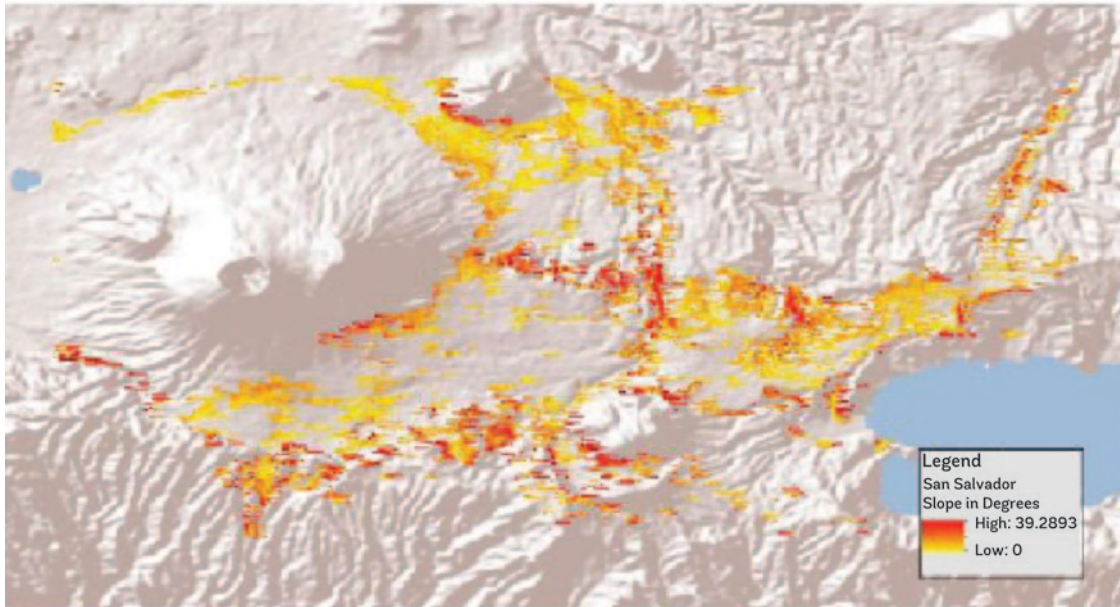
accumulation, lowering potential growth in the medium- to long-run. A study on the effects from 6,700 cyclones on long-run economic growth found that income levels remain permanently lower than the pre-disaster trend line (Hsiang and Jina 2014).

The exposure to natural disasters combined with high population density contributes to a number of acute environmental challenges. El Salvador is particularly exposed to weather-related risks that are expected to become more frequent as a result of climate change. With a population density of 304 people/sq.km. (ten times the LAC average), El Salvador is one of the most densely populated countries in the world and over 50 percent of its geography is mountainous. This contributes to a number of acute environmental challenges. Deforestation in the upper reaches of river basins and inadequate land-use management in both rural and urban areas have led to over a quarter of the land in El Salvador being affected by degradation, calling for better land-use management. Limited enforcement of building codes has led to the proliferation of settlements in increasingly steep slopes in the periphery of the main cities (see map 4.1).

Rapid and largely unplanned urbanization over the past decades has exacerbated environmental challenges and the impact of disasters. The character and severity of impacts from disasters depend not only on the extreme characteristics of the events itself but also on other factors such as environmental degradation, rapid and unplanned urbanization, and inadequate land use practices that contribute to increasing trends in exposure and vulnerability to natural hazards. Average annual urban growth rate was 2.9 percent between 1970 and 2000 (and remains currently at around 1.4 percent

MAP 4.1 Precarious Housing Adds to the Vulnerabilities Faced by the Bottom 40

San Salvador expansion, 2000–2010



Source: World Bank.

Note: Red areas indicate new settlements in the steepest slopes.

annually while the rural population is decreasing by 0.7 percent annually). Limited urban planning and the high prevalence of poverty in urban areas has led to around 30 percent of urban dwellers living in slums with limited public services and exposed to risks, in particular the lack of adequate drainage increases the probability of landslides and floods. In addition, limited enforcement of land use regulations and poor construction practices have led to the proliferation of settlements in increasingly steep slopes or along the river protection areas in the periphery of the main cities, increasing exposure and vulnerability to hazards such as mudslides (World Bank 2014a,

adapted from PCC 2012. *Managing the Risks of Extreme Events and Disasters to Advance Climate Change Adaptation*).

More than 80 percent of the population lives in municipalities exposed to at least three types of disaster risks. There are few measures to fully evaluate the factors affecting social vulnerability and to measure the impact of disaster on poverty, and, to date, limited quantitative evidence exists which can identify the causal impact of disasters on shared prosperity and poverty (see box on knowledge gap below). A study of the impacts of Tropical Cyclone Agatha in 2010 in Guatemala finds that the storm resulted in a sizable and possibly persistent deterioration

of human welfare among affected households, affecting their capacity to finance consumption of food and durable goods, as well as their children's education, and pushing some of them back into poverty, and that urban households were as vulnerable as rural ones (Baez et al. 2015).

Acute environmental challenges

Urban air pollution, including indoor air pollution (IAP), has important health impacts. Current air pollution in El Salvador is above WHO guidelines. With increasing urbanization and increasing use of automobiles, these figures are expected to increase. Air pollution levels in urban areas in El Salvador are already beyond the regional average and continued urbanization is likely to further add to this in the future. Further, more than 20 percent of people still use solid fuels for cooking, which is above the regional average. The use of solid fuels is the main source for IAP and has important health impacts. The WHO estimates that IAP causes 22

deaths (per 100,000) and 495 Disability-Adjusted life years (DALYs) lost.⁶ Continued high levels of air pollution will impact productivity across all groups of society and will impact health and education situation, especially of children and young adults. Finally, energy subsidies on petroleum products not only distort markets in favor of inefficient energy use, but also add to the fiscal burden.

Solid waste management is still limited. Only half of the population in El Salvador is served by municipal waste collection, which is much lower than other countries in the region. With increased available cash income through economic development and remittances, demand for consumption goods is likely to increase with associated accumulation of solid waste. A specific area of solid waste management is the emergence of medical waste that comes with the increase in health care facilities and health services and requires special disposal management.

KNOWLEDGE GAP What Is the Impact of Frequent Natural Disasters on the More Vulnerable?

Identifying the causal effects of disasters on poverty and shared prosperity is challenging but necessary. Although the occurrence of a natural hazard could be considered exogenous, its transformation into a disaster is not. Less resourceful households located in hazard-prone areas are more vulnerable to the impacts of disasters and have less resilience to recover from them. While an exercise to understand the intersection of local exposure to climate sensitive hazards and social vulnerability was recently carried out for El Salvador (Amaya and Cabrera 2012), there is still a need to better understand this relationship and importantly fully integrate hazard exposure and social vulnerability into a comprehensive vulnerability assessment for the country, the linkages between disaster and poverty in El Salvador and how to improve coping and adaptive capacities for the poor.

Herbicide use is inadequately managed. The use of herbicides in Salvadoran agriculture is significantly higher than in other countries with possible future impacts on rivers and other aquatic systems, underground freshwater aquifers, and ocean pollution. Throughout the value chain, herbicides pose a significant health risk for all humans working or handling these agro-chemicals as well as those exposed to improper management and disposal.

Improving land-use management. With over a quarter of the land in El Salvador affected by degradation and 16 percent of the people affected, land degradation has traditionally been a challenge in the country and has been driven by high population density and the mountainous geography (over 50 percent of El Salvador is mountainous).

Environmental issues in urban areas are driven by rapid urbanization and the relatively high share of the population living in slums. The degree of urbanization (65 percent) is below the Latin America average (79 percent), but the urban population grows at 1.4 percent annually while the rural population is declining at an annual rate of -0.7 percent. Limited urban planning and the high prevalence of poverty in urban areas has led to around 30 percent of urban dwellers living in slums with limited public services and exposed to risks. Only half of the population is served by municipal waste collection, which is much lower than other countries in the region, and IAP levels in urban areas due to the use of solid fuels for cooking are also higher than the regional average and are estimated to cause 22 deaths per 100,000 people (WHO).

There has been progress in expanding access to water and sanitation, although coverage is still not universal. While El Salvador

is on track to reach the MDG's water and sanitation targets, sustaining the achieved results is compromised by rapid urban population growth and an insufficient investment in the sector. The population without access to improved drinking water services decreased from 26 percent in 1990 to 12 percent in 2010, and the population without access to improved sanitation services decreased from 25 percent in 1990 to 13 percent in 2010. There are some regional differences with urban areas enjoying higher access (94 percent in water and 89 percent in sanitation) than rural areas (76 percent in water and 83 percent in sanitation). Existing services show important quality limitations: 48 percent of the drinking water supply is qualified as intermittent, 50 percent of the population reports deficiencies in the quality of water provided, and only 4.5 percent of the population reports that wastewater receives some treatment.

Investments in urban water and sanitation have been insufficient to offset urban population growth. The lack of investment is especially critical in urban sanitation, where the MDG targets will not be met and the coverage levels may continue decreasing. Furthermore, the current tariff schemes do not cover operation costs, result in low quality services, and represent a barrier to service expansion.⁷ The efficiency of the sector is low as over 40 percent of the water is not billed for as a result of high losses stemming from old infrastructure, theft, or high consumption from users to which a flat rate is billed (31 percent of users were not metered). Ninety percent of consumers are effectively receiving subsidized water yet the water sector accounts for over two thirds of all the complaints that the national consumer protection agency receives (UNDP 2010, 146-49).

The bottom 40 lives in more precarious housing, more vulnerable to both natural disasters and crime. Despite the destructive impact of the 2001 earthquake the main housing deficit is not a quantitative but a qualitative one. Some 41 percent of households experience some deficit in their housing in access to services (electricity, water, sanitation), quality of materials, overcrowding, or lack secure tenure (see appendix). This puts El Salvador in the fifth place among 18 Latin American countries in housing deficits. While there has been a steady improvement in the materials used, the rapid expansion of urban areas has often taken place with limited planning. Urban population growth is being accompanied by large increases in the urban footprint.⁸ Settlements have often been built in steep slopes, which add to the risks of mudslides (see map 4.1). Settlements in peri-urban areas are also more likely to be affected by criminal activity. The lack of adequate housing, together with low quality, or in some cases no public services in the neighborhood, perpetuates inequality and undermines shared prosperity.

Climate change makes it all the more critical to address these environmental and disaster-related challenges. El Salvador is particularly exposed to weather-related risks that are expected to become more frequent as a result of climate change, such as hurricanes, floods, and droughts. Climate change is also expected to affect in the long-run the viability of traditional crops such as coffee. Although coffee has long ceased to hold the preeminent place in the Salvadoran economy that it held during much of the twentieth century, exports of coffee still amounted to around \$300 million (or 6 percent of exports) and coffee is the second largest crop in area under cultivation after corn.⁹ Coffee is still an important source of employment in rural areas,

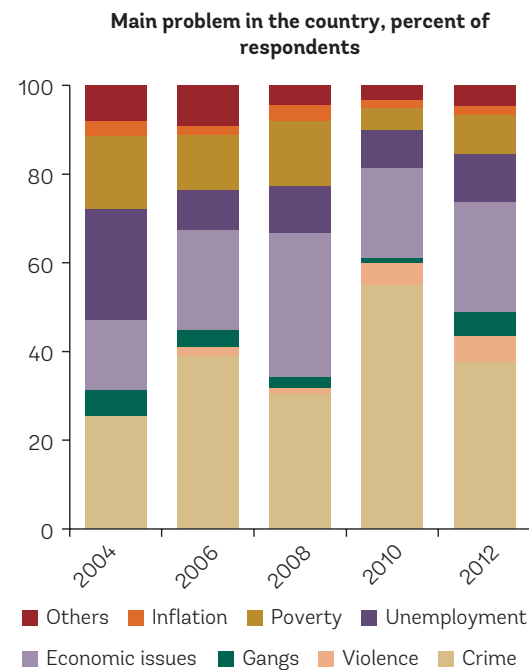
with the coffee harvest alone providing approximately 130,000 jobs.

Social Sustainability

THE MAIN CHALLENGE TO SOCIAL sustainability stems from high levels of crime and violence. Salvadorans increasingly identify crime as the biggest problem in the country (see figure 4.4), more so than in any other country in Latin America (see figure 4.5).

The risks of violence affect disproportionately the bottom 40. One way in which violence affects the bottom 40 disproportionately is in public transport in urban areas, which is used largely by the less well-off and which has been particularly hard-hit by

FIGURE 4.4 People Increasingly Identify Crime as the Main Problem in the Country

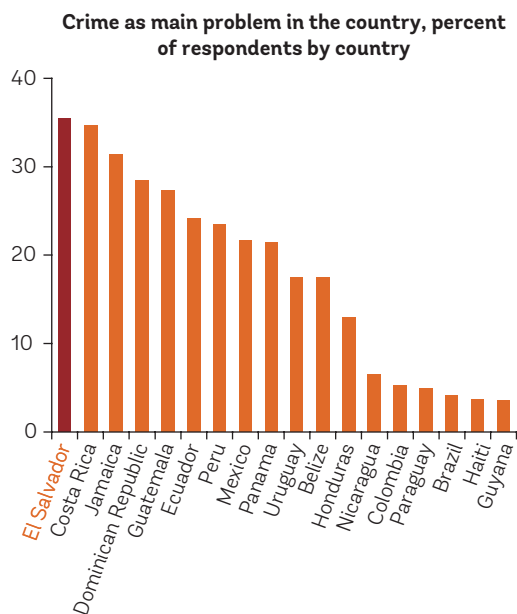


Source: LAPOP.

KNOWLEDGE GAP How Does Crime Affect the Welfare of the Bottom 40 Percent?

There is limited information as to how crime affects the welfare of the bottom 40 percent. However, data collection in this area is necessarily difficult and existing surveys of perceptions or victimization are not without caveats. Efforts to improve data and to analyze it would be critical to support an evidence-based approach to policy-making in this area.

FIGURE 4.5 Crime Is Seen as a Bigger Problem in El Salvador than Elsewhere in LAC



Source: LAPOP.

criminals (USG-GoES 2011). Protecting the labor force while transiting to and from work will help increase the welfare of the population as a whole and of the bottom 40 in particular since they are particularly reliant on public transport.

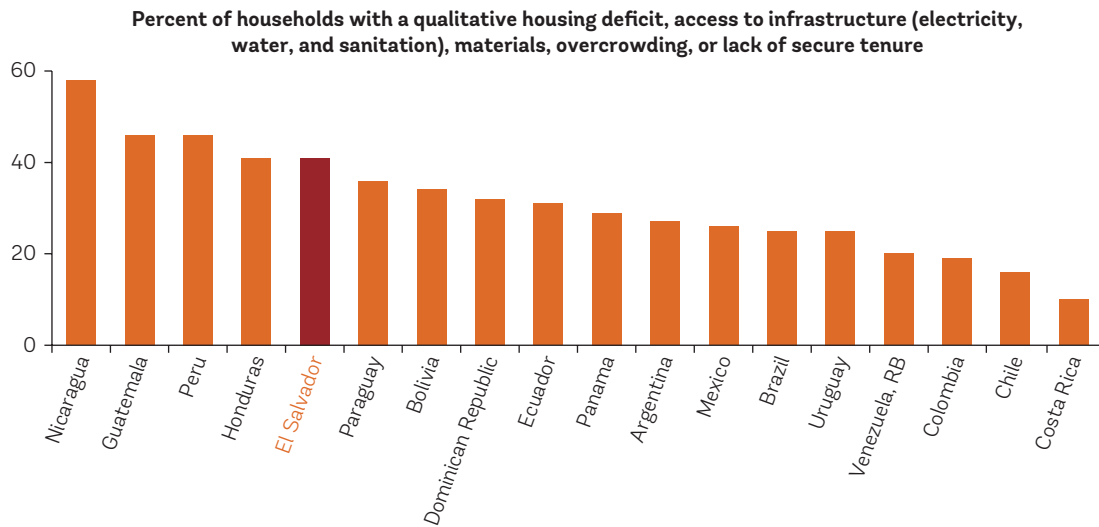
Slums create added pressures on social sustainability. As slums have become common

in all urban centers the share of households that live in such setting closely resembles the bottom 40. In fact, around 41 percent of households are considered to suffer a qualitative housing deficit (see figure 4.6), among the top five highest in Latin America and the Caribbean. Slums are one of the well-known environmental risk factors that contribute to crime and violence. Social vulnerability and socioeconomic conditions also influence coping and adaptive capacities with regard to hazards posed by natural disasters.

A number of challenges in tackling crime and violence relate to the area of justice and security (World Bank 2013). Overall, limited comparable data—for example on spending in prevention—as well as limited impact evaluations of interventions pose challenges to derive evidence-based policies. In addition to strengthening the statistical capacity, coordination efforts to develop a comprehensive plan for the sectors—possibly based around key indicators and through a results-informed budgeting framework, appear to be the most promising areas for engagement. With regard to specific areas in the justice and security sector—beyond prevention—key issues are as follows:

Police patrolling was the primary destination of security spending. In 2011, almost 45

FIGURE 4.6 Poor Housing Creates the Conditions for Crime to Thrive



Source: Bouillon 2012.

percent of security spending was dedicated to this purpose. The overall composition of spending in Police Patrolling had not changed significantly during the last five years. Costs associated with personnel are by far the largest component, accounting for almost 80 percent of expenditures. Goods such as fuel, tires and car parts, guns and other equipment together with uniforms and food represent the second main source of spending (13 percent), followed by investments (3.3 percent), services (2.8 percent) and financial costs (1.2 percent).

Public spending on crime investigation and prosecution of charges is low compared to other segments of the security and justice services chain, but resources have been increasing faster than the workload. Combined, spending on Investigation from the police and the Attorney General's Office represent half or the resources spent by criminal courts and one third of the expenditures on police patrolling.

The Judiciary is the only segment where public spending has been falling systematically as a share of total security and justice spending. Spending on personnel represents the largest and a growing share of the spending in the justice or judiciary segment.

Public spending in prisons and rehabilitation increased during the period, but it was not enough to meet the needs of this task. Spending has increased by almost 30 percent more than the total spending in the sector. The penitentiary system is in poor condition, unable to support its current population and, much less, to rehabilitate prisoners to be re-inserted in society.

Challenges regarding the human resources in the justice and security sector seem to be more qualitative than quantitative. The country has one of the highest numbers of police, prosecutors and public defenders in the region.

Identifying Policy Areas to Buttress Sustainability

BASED ON THE ANALYSIS PRESENTED above the following policy areas emerge as critical to boost sustainability:

Strengthening the fiscal position

Public debt sustainability in El Salvador hinges mainly on sustaining fiscal discipline and strong economic growth. El Salvador's challenge is to stabilize and eventually reduce its debt level to create much needed fiscal space for growth and poverty reduction purposes and keep financing requirements manageable. While growth plays a key role in ensuring the sustainability of the fiscal position, reforms are needed to avoid further deterioration of the debt ratios. Fiscal adjustments will require measures to increase revenue, reduce/reassign expenditures, and improve public expenditure management as well as debt management.

The main challenge on the revenue side is to achieve sustainable increases while avoiding that uncertainty over the tax framework further discourages investment. Over the last years tremendous efforts have been made at increasing revenue. Tax revenue has increased by almost 2 percent of GDP between 2008 and 2013—from 13.5 percent of GDP to 15.3 percent of GDP. This objective has been achieved through various measures including changes in tax rates, simplifying the tax system and tax administration. However, El Salvador still generates lower revenues than would be required by their substantial unmet social and infrastructure expenditure needs. Over the recent past, El Salvador has been running a primary fiscal deficit of well above

1.1 percent of GDP, which contributed to the large increase in debt. Tax adequacy is also low considering international and even regional trends. On average, regional tax revenue is estimated at 17.5 percent of GDP. Comparing El Salvador's performance with that of other Latin American countries suggests that there is room for improving tax revenue performance. Possible measures include but are not limited to increasing tax rates such as the VAT, limiting tax expenditures, creating new taxes, and improving enforcement. Revenue mobilization efforts will help alleviate the fiscal situation but, as noted above, it is also important to strike the right balance between revenue raising efforts and providing a stable and predictable tax system.

The challenge in managing expenditure is complex and requires a good balancing act given the social and economic needs. El Salvador's total Non-Financial Public Sector expenditure has averaged over 22 percent of GDP since 2008, increasing from 20.6 percent of GDP in 2008 to 23.8 percent of GDP in 2013. Overall public investment is low at 2.9 percent of GDP in 2013. Equally, social expenditures are still relatively low. Reducing drastically social expenditures in this context could be counterproductive given the magnitude of the social needs. These aspects limit the prospects for reducing social expenditures significantly. However, as noted in Chapter 3 on inclusion, there is scope for improved targeting of social expenditures. Analyzing it from the budget structure angle, the potential for reducing expenditures substantially is also complicated by the structure of current expenditures. The bulk of current expenditures is allocated to salary and wages (37 percent of the budget), goods and services (19 percent of the budget) transfers—mainly subsidies—(17 percent of the budget), and interest payments

(12 percent of the budget). Salary and wages and interest payments are rigid, therefore expenditure reduction is likely to be limited to goods and services and subsidies, the latter posing the greatest challenge but also potential opportunity.

Improve the country's disaster resilience

Move from a reactive to a preventive approach. Natural disasters hit the poor and bottom 40 given where they live. It is critical to move from a reactive to a preventive approach to disaster risk management to increase disaster resilience. In addition, risk reduction and mitigation measures could be enhanced.

An effective budget management strategy that allows for the rapid mobilization of resources in case of a disaster while protecting fiscal accounts. Ideally this strategy combines budget allocation and reserves, contingent funds, and risk transfer instruments to safeguard against disasters of all layers of frequency and magnitude.

There is a need to improve knowledge and assessment of disaster risk in order to reduce existing high levels of vulnerability in public assets. Such public assets span the education, health and other infrastructure sectors. A probabilistic risk assessment of 20 percent of the educational infrastructure in San Salvador, conducted under the umbrella of the Central America Probabilistic Risk Assessment Program (CAPRA), demonstrated the high vulnerability of school buildings and the necessity to ramp up efforts to make them resilient to natural hazards. It is important to conduct additional assessments that provide complementary understanding of the vulnerability of public, and especially school, buildings, and improve current practices to mitigate or avoid

those risks. Overall, stronger focus is needed on the structural dimensions of resilience.

It is also key to improve territorial and sector planning processes to appropriately integrate risk reduction criteria. In order to promote efficient disaster risk management and reduce vulnerability, substantial efforts are needed to augment the knowledge base of disaster risk at the local and sectoral levels. In addition to information and data, disaster risk management needs to be better integrated into the urban development decision-making process. To this end, it is critical to strengthen the institutional framework and capacity for including disaster risk management in land use planning and building codes and enforcing their application. In this context, the improvement and application of risk management in planning tools is needed to help reduce the constant regeneration of unacceptably high levels of vulnerability generated from inadequate land use and water management as well as inappropriate building practices.

There is a need to bring programs and plans up to scale to cover the entire country to benefit from a climate smart landscape approach. Mitigation actions in the land use sector could bring substantial benefits for adaptation to climate change. An inter-sectoral approach would enhance tackling the key drivers of forest loss and landscape degradation, and expansion of non-sustainable agricultural and livestock activities; urban growth and infrastructure development; illegal logging and firewood extraction; forest fires; and the expansion of productive activities into mangrove ecosystems because of the economic value of these ecosystems and their importance for rural development and poverty alleviation. There is a need for finance options towards an adaptation-based

mitigation approach, which is framed under The National Program for the Restoration of Ecosystems and Landscapes (albeit with no budgetary provisions at the moment), such as strengthening the coffee plantations which are mainly managed in the modality of shade coffee and serve as a complex agroforestry system.

Provide security

Focus on prevention. Crime and violence is preventable. Still the Government of El Salvador only spends 3 percent of its citizen security budget in prevention. Prevention is the most efficient way of responding to crime and violence and should be a key component of any sustainable strategy for the promotion of citizen security and social development. There are rigorously evaluated interventions that have demonstrated the success and

cost-effectiveness of this approach. This is particularly the case for youth violence prevention.

The importance of a broad national consensus. The authorities need to generate a national consensus around a minimum set of principles and objectives to guide a comprehensive citizen security policy in the country, bringing all major parties, private sector, civil society, and development partners together.

Protecting youth at risk. One of the key challenges and opportunities of the new administration is how to develop effective approaches to protect youth at risk from joining gangs. One way to do this is by supporting municipal based approaches that integrate the territories and populations with high concentration of gangs with the rest of municipality in terms of access.

Notes

1. While state capacity is notoriously difficult to benchmark across countries, an indicator such as the institutions pillar of the Global Competitiveness Report shows El Salvador lagging behind the averages for the region, lower middle income countries, the world, and the set of structural peers.
2. From 1992, when the VAT was introduced, to 2005 indirect taxes accounted for 70 percent of all tax revenues. Despite efforts to increase income tax collections that ratio is still around 63 percent as of 2013.
3. During this period, the country passed 13 tax reforms, including the creation of new taxes on specific goods and increasing rates (corporate and personal income tax, and selective taxes on consumption).
4. The fiscal position was already, however, under increasing stress even before the global economic crisis. Estimates of the cyclically adjusted fiscal balance suggest a structural deficit that had been growing steadily every year from around 2.7 percent of GDP in 2000 to 4.2 percent of GDP in 2010 (Oliva 2011).
5. The key assumptions in this baseline scenario for the debt sustainability analysis were as follows: (a) GDP growth was expected to average 1.9 percent over 2014 to 2019, which is equal to the historical average from 2003 to 2013; (b) Primary expenditure was projected to remain higher than revenue leading to an average primary deficit of 1.6 percent of GDP.
6. DALYs represent the sum of years of potential life lost due to premature mortality and the years of productive life lost due to disability.
7. MAPAS (2014).
8. The three largest metropolitan areas, San Salvador, Santa Ana, and San Miguel grew in size during the first decade of this century by 30 percent, 120 percent, and 60 percent respectively (World Bank 2012c).
9. Data refers to 2012 which, given the impact of the coffee leaf rust in bringing down output and exports since 2013, may better reflect the medium-term conditions of the sector.

5. Synthesis and Priorities

TO GO BEYOND THE PROXIMATE CAUSES of El Salvador's stagnation requires us to address also why it has proven so difficult to make progress and on which strengths can the country build. To identify the policy areas that could have the most impact in boosting shared prosperity in El Salvador it is not enough to undertake the benchmarking exercise and above analysis. Simply doing so would ignore two additional aspects. First, it is important to consider why, despite many efforts, it has been particularly difficult to make progress. Second, despite the numerous challenges discussed above, El Salvador has some existing strengths on which it can build. Any systematic diagnostic of the situation in the country cannot overlook those strengths and the potential they bring.

Why Has It Proven So Difficult to Make Progress?

IN THE MIDST OF A CIVIL WAR, the early 1980s was a period of economic policy uncertainty and increased state interventionism. In the midst of the civil war that affected the country in the 1980s a number of drastic changes affected significantly the economic policy environment. As the civil war intensified the country faced a severe economic crisis which brought down per capita Gross Domestic Product (GDP) by 25 percent, halved exports, and pushed inflation up to 20 percent in the first three years of the 1980s. In the midst of this crisis, and in an effort to support for the insurgent groups, the

government increased the degree of intervention in the economy, introducing price and exchange controls, increased public spending, nationalized banks and directed credit, and took over the exporting of sugar and coffee. These measures were ineffective and were also broadly rejected by the private sector (UNDP 2013, 87).

This was followed by a swift adoption of liberalizing reforms in the 1990s and 2000s. By the early 1990s, in a much different context characterized by the signature of the peace agreements in 1992 and the end of the cold war, the country set out to implement a sweeping reform agenda aimed at opening up the economy and reducing the degree of state intervention. More than 250 price controls were dismantled from 1989 to 1994 and the regulatory framework for privatizing key sectors such as banking, electricity, and telecommunications was enacted. Privatizations in those sectors then took place throughout the 1990s. The state also divested itself from many other activities it had come to operate, including sugar mills, free trade zones, hotels, cement, etc.). El Salvador joined the Generalized Agreement on Tariffs and Trade in 1990, eliminated export taxes on sugar and coffee, reduced unilaterally import tariffs and eliminated most non-tariff barriers. It also enacted new laws for free trade zones and the promotion of exports in 1990. The record of policy reforms continued into the 2000s. For example El Salvador became one of the top reformers in the *Doing Business* indicators in the mid-2000s.

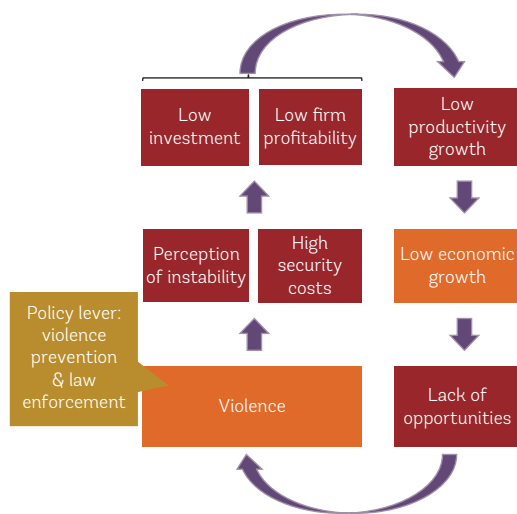
In summary, El Salvador's underperformance has taken place despite relatively

ambitious policy reforms in the last two decades. El Salvador has been, as a well-known diagnostic put it, a star reformer but, however, it has not been a star performer (Hausmann and Rodrik 2005). Addressing this puzzle is the subject of the next section of this diagnostic.

A hypothesis: three vicious circles reinforcing stagnation

The challenge in El Salvador is not to identify the proximate causes of its relative stagnation but how those causes are interconnected and what entry points there may be to break what can be characterized as vicious circles. The hypothesis explored here is that progress towards the goal of boosting shared prosperity has been hampered in El Salvador by a number of vicious circles that have reinforced stagnation and has made efforts at effecting change ineffective.

FIGURE 5.1 Vicious Circle of Low Growth and High Violence



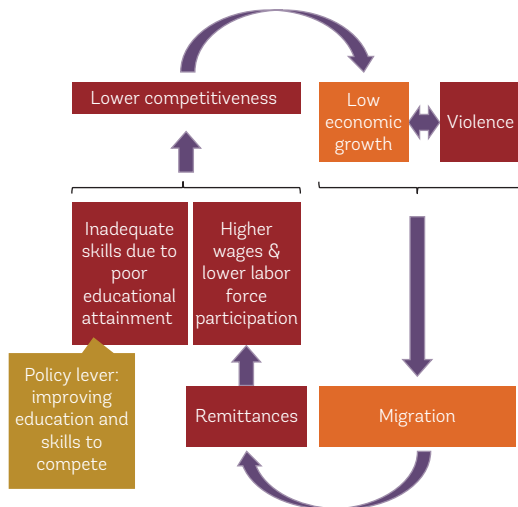
Vicious circle of low growth and high violence

There is a vicious circle between low economic growth and violence. Low growth limits the income and the opportunities of the population, therefore creating incentives for some individuals to join a gang or *narco* group which may offer significant short term earning opportunities (particularly in countries where impunity levels are high and the gangs have a strong and widespread presence in the country). In turn, high levels of violence (El Salvador is one of the three Central American countries where the homicide rate is at the top of global rankings) have a significant negative impact on the investment climate (security costs in El Salvador represent about 3.5 percent of firms annual sales, and these is increasing evidence that crime and extortions are prompting firms to exit the market place altogether). The higher risks and costs of insecurity deter investment and reduce firm profitability resulting in lower productivity growth—which in turn hampers overall economic growth in a self-reinforcing negative cycle.

Vicious circle of low growth and migration

Limited growth and the ensuing lack of opportunities are pushing many to migrate. The main motivation for Latin American migrants is economic (Niimi and Ozden 2008, 52). There is a large real wage gap that keeps attracting immigrants to the US. The average annual earnings of a Salvadoran immigrant working full-time in the US in 2011 was \$33,600 for men and \$26,400 for women (CEMLA 2013). This results in a per capita income for Salvadorans in the US of around

FIGURE 5.2 Vicious Circle of Low Growth and Migration



\$19,800 or more than five times higher than the equivalent per capita income in El Salvador. Significantly, this ratio has not shown signs that it is decreasing significantly (the per capita income of Salvadorans in the US in 2004 was slightly less than six times that in El Salvador; UNDP 2005).

Another key push factor for migration is the situation of widespread violence. While it is difficult to pinpoint exactly the causes of migration one source of information stems from the LAPOP surveys that capture an individuals' intention to migrate as well as many individual characteristics. Based on such data, estimates on the determinants of the intention to migrate among Salvadorans find that, in addition to the economic situation, other variables that are also strongly correlated with the intention to migrate include the degree of satisfaction with one's life, having relatives abroad, victimization, and age (Arnold, Hamilton, and Moore 2011).

High migration rates have led to the high importance of remittances, with beneficial impact on the welfare of recipients. Both the volume and the importance of remittances as a share of GDP have seen a trend increase over the last two decades, although the global economic crisis put a temporary pause in this trend. At over 16 percent of GDP remittances are an important source of income for many Salvadoran households. Around 13 percent of households in the bottom 40 receive remittances, a share which has been relatively stable over time, while the corresponding figure for the top 60 is 18 percent. As in other countries, households at the very bottom of the income distribution are less likely to be recipients of remittances (among the lowest decile only 8 percent of households receive remittances). This is in part driven by the fact that receiving remittances is likely to increase income so significantly that the household may no longer be in the lowest decile of the income distribution. While many households in the top 60 percent receive remittances the overall share of remittances in their income is much smaller than for the bottom 40. As a result remittances have an equalizing impact. Estimates suggest that without remittances the Gini coefficient would be around 2 percentage points higher (Acosta et al. 2008). Among recipient households remittances reduced poverty at the \$2/day by 40 percent in 2000.

Remittances are contributing to a Dutch disease syndrome through higher wages and real exchange rate appreciation. Increases in capital inflows lead to an increase in consumer demand while, as households see their incomes rise, reservation wages increase and labor supply falls. In a small, open economy, this translates into an increase only in the

price of non-tradable goods and services, leading to a reallocation away from the tradable sector to the non-tradable sector and a real exchange rate appreciation. Among Latin America and the Caribbean (LAC) economies, the impact of a one percentage increase in remittances as a proportion of GDP is estimated to lead to a real exchange rate appreciation of 2.5 percent if remittances are taken as exogenous, and 18–24 percent if the models correct for reverse causality in which real exchange rates also affect the migrants decision to send remittances (Lopez, Molina, and Bussolo 2008). Lartey, Mandelman, and Acosta (2009) confirm Dutch disease in El Salvador, finding real exchange rate appreciation due to remittances using quarterly macroeconomic data. Furthermore, they find that both altruistic remittances (which are largely directed to consumption) and self-interested remittances (investments by migrants) result in a reallocation of resources to the non-tradable sector and a real exchange rate appreciation.

The real exchange rate appreciation undermines competitiveness. A computable general equilibrium (CGE) modeling exercise undertaken for this SCD sheds light on the mechanisms through which competitiveness of the Salvadoran firms is affected by remittances. A simulated increase in remittances would lead to increase in prices (especially in services), wages, and imports, and will result in a decline in exports, especially of textiles (see box 5.1).

Migration has also reduced the labor force significantly. In its most direct way migration implies the removal of a labor force that otherwise would be available in country. Estimates suggest that there is a negative contribution of migration through brain drain as the country spends more educating

migrants than it receives as remittances (Cabrera 2011 as quoted in USG-GoES 2011). The impact of this removal from the domestic labor force is aggravated by the fact that migrants are a self-selected group which tends to be more educated—as is indeed the case among Salvadoran migrants—and more entrepreneurial. As a result migration may lower both the contribution of labor to growth but also had an impact on labor productivity growth.

Migration has also contributed to the reduction in the labor force indirectly: females in households that receive remittances have lower labor force participation rates. Microeconomic evidence has uncovered that remittances reduce labor force participation for women at all ages, with a higher negative impact at younger ages, presumably allowing maternity options or home-based activities (Acosta 2006). The finding that receiving remittances reduces the participation of women in the labor force explains the horizontal arrow between remittances and dropping out of the labor force shown in figure above.

And migration may be undermining the incentive of the youth left behind to invest in education. Although returns to education are high in El Salvador and Guatemala, returns to education in the U.S. among Salvadoran are low (much lower than for those born and educated in the US) and educated Salvadoran immigrants often end up in low-skilled jobs in the US. This may be because of the low quality of education in Central America, or because incompatibilities in the education systems mean that employers in the US do not value the education immigrants have received in El Salvador. On top of this, wages for low-skilled labor in the US are often higher than those for high-skilled

BOX 5.1 Implications of Remittances: Results from a CGE Model Estimation

Using a CGE model, Global Trade Analysis Project (GTAP), we simulate an increase in the amount of remittances equal to seven percentage points of total household income. This figure was selected given that remittances were growing at annual rate of around 7 percent in the pre-2008 period. We assume that all of the simulated income change comes from the household income in North America and is transferred to the households in El Salvador without incurring any cost. We also assume that the change in remittance income would not affect government consumption in nominal terms. Furthermore, we assume that capital and labor are fully mobile across sectors while land is partly specific to crops.

The results suggest that the simulated increase in remittances would raise domestic prices in El Salvador by 1.4 percent. The commodities with the greatest increase in domestic prices include services (1.6–2.3 percent) with food prices rising more modestly (1.2–1.4 percent).

Not all incomes are expected to keep up with the pace of general price increase following the increase in remittances. While the nominal increase in the return to skilled labor is expected to be 3.2 percent, unskilled wages are likely to grow by 1.5 percent, barely exceeding the level of consumer inflation.

The simulated increase in household incomes would result in an increase in real GDP equal to 0.3 percent. However, not all sectors would grow as a result—in fact many would shrink considerably, especially the production of textiles and apparel (a reduction of 7.2 percent), followed by the manufacturing (a reduction of 2 percent). The main sectors experiencing an expansion are various service sectors (0.1–1.9 percent) and meat and livestock production (1.8 percent).

Finally, the increase in remittances would increase the volume of imports into El Salvador (5.1 percent) and reduce exports (9 percent). Most of the increase in imports would involve the importation of meat and livestock products (7.6 percent), followed by processed foods (5.8 percent) and manufactured goods (5.6 percent). Exports of all major categories would experience a decline, for example exports of textile and apparel and manufactured goods would decline by around 10 percent.

labor in El Salvador. If one's intention is to migrate, as many youth do, investing in an education in El Salvador may not result in higher returns in the US market.¹ Still, it remains somewhat of a puzzle why so few

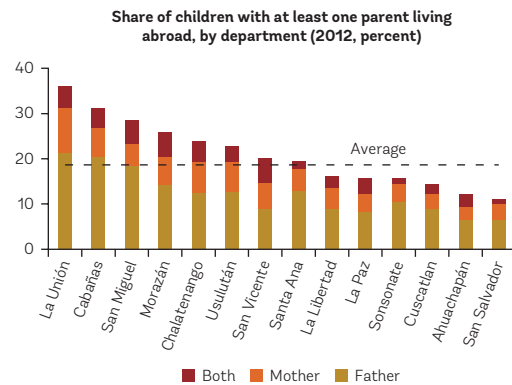
Salvadorans would invest in English language learning given the high returns that the skill yields, especially in the US labor market. In fact, 71 percent of Salvadoran migrants in the US report speaking only some

English (CEMLA 2014). The limited investment even in skills that would yield high returns even in the US, such as English language skills, suggests that besides incentives other factors may be at play.

Parental absence due to migration may also be having an effect on the children's education. Disentangling the effects of migration on human capital formation is difficult. On one hand, remittances provide income that is often used to keep children in school—and indeed this is the case in El Salvador where receiving remittances increases school attendance among girls through the ages of 17 and boys through the ages of 14 (Acosta 2006). On the other hand, it has now been documented in other countries that the absence of parents because of migration, especially during children's adolescent years, can have a negative effect on the behavior of children left behind (McKenzie and Rapoport 2006). For example, parental absence as a result of migration may translate into less parental inputs into education acquisition and may also require remaining children to undertake housework or work to help meeting short-term labor and cash shortages. In El Salvador, where currently 19 percent of all children live in households where at least one parent has migrated (see figure 5.3), the negative impact of parental migration on the children's investment in education may be significant.

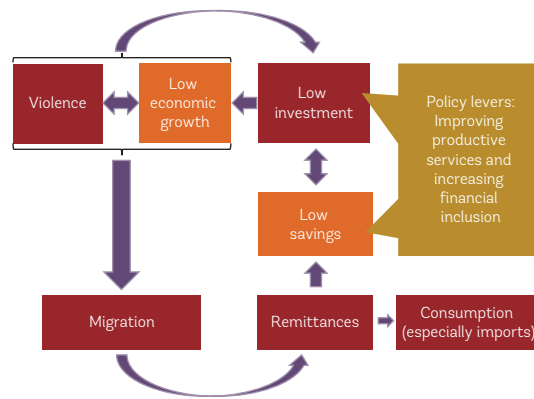
Overall, while migration and the accompanying remittances support welfare they also contribute to a stagnant economy. Estimates for the Latin America and Caribbean region suggest that remittances are also associated with increased economic growth: doubling the share of remittances in GDP is associated with growth increasing by 0.5–1.3 percentage points, with roughly half

FIGURE 5.3 Children Often Live in Households Where At Least One Parent Has Migrated



Source: World Bank staff based on EHPM.

FIGURE 5.4 Vicious Circle of Low Growth and Low Savings and Investments



of this growth resulting from remittances being channeled into increased investment (Acosta et al. 2008). However, in the case of El Salvador such an increase in investment has not materialized, and hence growth has not been boosted by remittances. The experience of El Salvador may stem ultimately from the fact that the greatest driver of rising remittances is rising migration, which has an

opportunity cost. Net of that cost, there may be little reason to expect large growth effects of remittances in the origin economy (Clemens and McKenzie 2014).

Vicious circle of low growth and low savings and investment

Receiving migrant remittances appears to lower the savings rate. When faced with limited access to credit and insurance markets, remittances have the potential to smooth consumption. There is little evidence, however, that remittances in El Salvador have been used as insurance. The propensity to save out of the remittances income is lower than the corresponding savings rate from non-remittance income (Acosta, Fajnzylber, and Lopez 2008, 139). Remittances in El Salvador are pro-cyclical, as they are sensitive to labor market conditions in the US, in contrast to the situation in other LAC countries, which respond to reductions in real output below trend with more than a proportional increase. At the same time, though remittances have resulted in increased consumption in El Salvador and consumer credit accounts for a significant proportion of private debt in El Salvador, receipt of remittances between 1995 and 2001 did not lead to higher consumer debt (Anzoategui, Demirguc-Kunt, and Martinez Peria 2014).²

In fact, El Salvador stands out as having a particularly low savings ratio. Gross national savings stood at an average of 11 percent of GDP in 2000–13, lower than any of its comparators (structural peers were closest, at 13 percent, averages for LAC, lower middle income countries, and the world were much higher at 16, 20, and 201 percent of GDP respectively).

This is normally explained by the lack of investment opportunities given the persistently low growth. Most analysts suggest that the main constraint behind low investment is the lack of profitable investment opportunities. The cost of capital is not particularly high either, which confirms this view (USG-GoES 2011). This constitutes a vicious cycle by itself, in which low investment leads to low growth and fewer investment opportunities, feeding into ever lower investment. The declining contribution of capital to GDP growth obtained from the growth accounting decomposition shown in figure 2.1 above is evidence that this vicious cycle is at play.

But low investment and low savings likely reinforce each other. In principle the low savings ratio is not necessarily a binding constraint for growth because the country could have access to foreign savings. In fact, under that logic, increasing the domestic savings rate in the absence of an improvement in investment opportunities would simply lead to those additional savings being invested abroad. In practice, however, investment and savings rates are highly correlated across countries. There are no shortage of explanations of this finding, long-known as the Feldstein-Horioka puzzle, but for our purposes it may suffice to note that in a world where investors exhibit home bias raising the savings rate could in fact help boost the investment rate.

And an underdeveloped financial system makes saving difficult. As noted above only 6 percent of the bottom 40 have an account in a formal financial institution, less than half the average in lower middle income countries and less than a third of the average in LAC.

Entry points: education, security, and financial inclusion

Education, security, and financial inclusion appear to be areas where efforts to break the vicious circles could potentially focus. A further discussion on prioritization will be undertaken later in this chapter but at this stage it seems appropriate to reflect on what possible entry points there may be to break the vicious circles. By their very nature, the vicious circles described above are difficult to break. Migration and remittances, for example, would appear to be relatively difficult to influence through policy interventions. Other areas, however, may be more amenable to policy action. Improving education or financial inclusion may be such areas. Improving security, while in itself a most difficult challenge, also appears to be a critical entry point given that violence is at the core of the vicious circles described above.

Opportunities: Building on Strengths

Making the most of remittances

Remittances are likely to remain a significant source of income for many Salvadoran households. Although Salvadoran migrants in the US remit a lower share of their income, around 13 percent, compared to Hondurans (27 percent) or Guatemalans (30 percent) (CEMLA 2014), trends in remitting have been broadly stable and driven by labor market conditions in the US. In addition, the outflow of migrants is still ongoing. Asked about whether they intend to migrate within the next three years, over 23 percent of Salvadorans they answer that they intend to migrate, one of the highest levels among Latin American countries

(LAPOP 2012 surveys). Given that, as discussed above, the most important correlate of the intention to migrate is age (with younger individuals more likely to report intending to migrate), and taking into account the still very young population (see population pyramid in figure 3.21 above), El Salvador is likely to continue experiencing outmigration and in turn receiving ever higher remittances.

How can remittances lead to higher savings and investment rates? Education and institutions are critical. The available literature suggests that remittances are more effective at raising investment and growth in countries with higher levels of human capital, strong institutions, and good policy environments (Calderon, Fajnzylber, and Lopez 2008, 366). This provides a further rationale for addressing education and skills and state capacity.

Education will not only help maximize the impact of remittances but it is also a binding constraint in and of itself. The decrease of earning premiums for secondary education since 1998 has led some to argue that there is only limited demand for an educated workforce and therefore no evidence that this is a binding constraint to growth (USG-GoES 2011). However, the percentage of firms in the Enterprise Survey that mention an inadequately educated workforce as their biggest obstacle has doubled between 2006 and 2010, from 3.7 to 7.4 percent (which is now above the average for lower middle income countries). And 30 percent of firms identify an inadequately educated workforce as a major constraint compared to only 6 percent of firms identify labor regulations as a major constraint. Sixty percent of firms state that the most difficult skills to find when hiring

are technical ones (which include ability to speak a foreign language, problem solving and analytical thinking). There is also evidence that educational provision does not adequately meet demand in the science and technology sector (UNCTAD 2011). Efforts at workforce development and training can result in higher skilled job creation and attraction (USAID 2008). Overall, there is increasing evidence that education is a binding constraint to growth.

Exploring ways to increase the savings rate out of remittances would also be important. While remittances in El Salvador have historically been spent on consumption goods, recent research suggests that creating tools that enable immigrants to have more control over how remittances are spent would lead to more savings and investment. In a randomized experiment setting, Ambler, Aycinena, and Yang (2014) found that providing matching funds for educational remittances in El Salvador led to increased educational expenditures (\$3.72 for every dollar received), higher private school attendance and lower youth labor supply. However, the take-up rate by migrants was low, with only 18.5 percent of migrants offered a 3:1 match and 6.9 percent of migrants offered a 1:1 match taking part in the program. In a separate randomized controlled trial among Salvadoran immigrants in the Washington, DC metropolitan area, Ashraf et al. (2015) found that senders of remittances would prefer that remittances be saved at a higher rate than remittance beneficiaries (21.2 percent versus 2.6 percent). Additionally, when migrants were given more control over how remittances were spent through shared savings accounts they remitted more and the recipient household saved more. In a related

development, advances in technology have facilitated the creation of commitment savings accounts that can be customized to an individual's goals and may help increase savings rates. Given the low levels of financial inclusion exploring innovative schemes through mobile banking would be worthwhile.

Making the most of geographic and cultural proximity to large markets

El Salvador's experience confirms that trade agreements create opportunities but do not guarantee results. The benefits of trade agreements appear to be related to a complementary agenda which includes the quality of institutions, human capital, infrastructure, and technology adoption and upgrading. In the case of Central America this complementary agenda is large (see Lopez and Shankar 2011). In the latest Enterprise Survey 27 percent of firms identified customs and trade regulations as a major constraint and 32 percent identified transportation as a major constraint. Improving connectivity is likely to give a boost to exports. Estimates from a CGE model simulation suggest that a reduction in trading costs of around 18 percent (equivalent to achieving the same transport costs as in the US-Costa Rica corridor) would increase exports by around 1 percent, although it would also increase imports, by around 1.5 percent (see box 5.2).

El Salvador's geographic and cultural proximity to the US provides a significant opportunity. The fact that El Salvador's population has a deep familiarity with the US culture and marketplace represents a potential asset. Geographic proximity to the US is

BOX 5.2 Implications of Lowering Trading Costs: Results from a CGE Model Estimation

Using a CGE model, GTAP, we simulate an increase in the efficiency of trading costs for trade between the US and El Salvador which would bring its costs down to the level of Costa Rica, which is the best regional performer in terms of import costs with the US. Bilateral trade costs between the US and Costa Rica are reported at \$80 per shipment in 2011, while they stand at \$95 for El Salvador; we therefore simulate an 18.7 percent improvement in the efficiency of transport services for trade.

The general macroeconomic impact of the reduction in trading costs is expected to be small due to the size of the shock, increasing domestic prices by only 0.1 percent and unskilled wages by 0.5 percent. The largest decline in prices is expected among textile and apparel (0.3 percent) manufactured goods (0.1 percent).

Even though the overall output of El Salvador would barely change, some sectors are expected to experience noticeable changes in output as a result of the simulated change in trading costs. The largest growth is expected to occur in textiles and apparel which would grow by 1.9 percent. The largest reduction is expected in the sector of other manufactured goods which is expected to contract by 0.9 percent.

The reduction in trading costs would also have a noticeable implication for El Salvador's exports, whose volume is expected to grow by 1 percent, and imports which are expected to grow by 1.5 percent. At the sectoral level, the largest increase in imports is expected for grains (3 percent) and textiles and apparel (2.4 percent). The greatest increase in exports is predicted for textiles and apparel (3.4 percent).

a contributing factor, in addition to having a vibrant air transport hub, behind the development of export markets for some services such as airline plane maintenance service. Proximity to the US is one of the factors that is supporting the development of the software industry in neighboring Guatemala. This is because thanks to the heavy flow of people back and forth from the US, developers of digital content are very in touch with North American culture, which gives them a competitive advantage. Being in the same time zone as the US and having a qualified

workforce with good English-language skills are potential factors driving El Salvador's competitive advantage.

Making the most of regional integration

The integration of markets and infrastructure networks has extraordinary power to stimulate growth through efficiency gains, technology spillovers and investment. However, despite several notable bright spots in economic cooperation, the promise of

greater regional integration among the Central American countries has remained largely unfulfilled. Central America's efforts at forming greater regional economic ties have been ongoing for decades, most notably on the trade side stretching from the establishment of a Central American Common Market in the 1970s to the Dominican Republic-Central America Free Trade Agreement and the EU-Central America Free Trade Agreement.

There have been several significant integration successes outside of trade, including in the energy sector. The *Sistema de Interconexión Eléctrica de los Países de América Central* (SIEPAC), a transmission line project which came into being in June 2013 and connects the electricity grids of Panama, Costa Rica, Honduras, El Salvador, Guatemala, and Nicaragua. While its benefits have so far been limited, that interconnection could enhance investment opportunities for large-scale energy projects, as well as improve the efficiency and the security of electricity supply in Central America. Further integration with Mexico, especially in the area of energy, could also help lower the costs of energy. Financial interconnectedness is also on the rise, with almost all the banks in the region expanding operations into neighboring countries, although differences in legal and regulatory frameworks have limited greater connectedness.

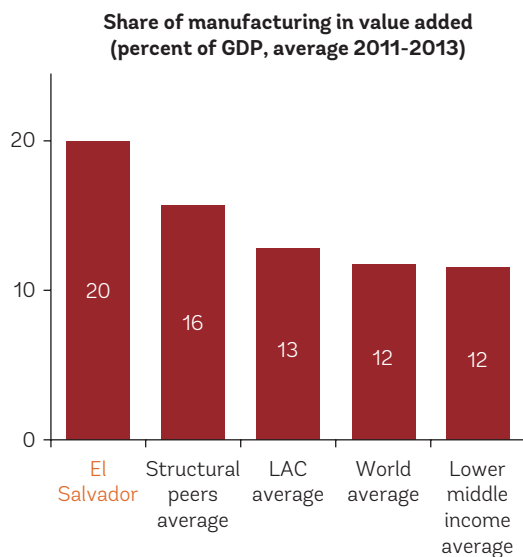
But Central America has not fully realized the gains expected from integration efforts. Exporters have not experienced appreciable growth in either export lines or markets since the signing of the regional free trade agreements. Bilateral trade in Central America remains an agenda of largely untapped opportunities, as evidenced by the negative elasticity of bilateral trade to

different factors including adjacency and time adjusted distance (Marcelo, Stokenberga, and Schwartz 2010). This untapped potential can be attributed to deficiencies in infrastructure, burdensome processes and congestion at the border crossings limiting trade, even where distances are short. Poor road quality, particularly on secondary and unpaved rural roads, has led to road transport prices averaging 17 cents per ton-kilometer in Central America, one of the highest road transportation costs in the world (Osborne, Pachón, and Araya 2014). In addition, port reforms are still pending. Burdensome customs procedures, lack of regulatory harmonization (for example in terms of phytosanitary standards for agricultural exports), few established trade linkages, an atomized shipping industry, sparse information sharing on cargo and backhaul in trucking, and relatively few options and competition for shipping also limit the gains from trade free trade agreements. Transport and logistics costs can surpass 50 percent of the final price of goods traded, and it has been estimated that intraregional exports in Central America could double if the region achieved the adjacency and time distance factors of a truly integrated region (Marcelo, Stokenberga, and Schwartz 2010).

Making the most of the manufacturing base

El Salvador retains a relatively large manufacturing base. At 20 percent of value added manufacturing is significantly higher in El Salvador than in the set of comparators (see figure 5.5 below). This high share of manufacturing is not the simply the result of the *maquila* boom in the 1990s. In fact, El Salvador has a long-standing tradition of

FIGURE 5.5 Higher Manufacturing Base than Other Countries



Source: World Bank.

manufacturing that dates back decades and established itself early on as the manufacturing center in Central America. Besides manufacturing El Salvador was also an early adopter of other technologically advanced areas of activity such as geothermal energy, which it started to produce in 1975 and on which it has become a regional leader. A number of industrial niches where El Salvador has seen significant export growth. As shown in figure 5.6 below, exports of organic chemicals, synthetic fibers, and special fabrics have multiplied by six or more since 2005, while exports of plastics have roughly tripled since 2005. Plastics have now become the second largest export good after textiles (in a classification of exports into 98 product groups). The increase in the export of plastics, which went from 3 percent of total exports in 2005 to 6 percent of total exports in 2013, as well as related groups such as synthetic

FIGURE 5.6 Dynamic Export Performance in Selected Manufacturing Sectors



Source: Central Bank of El Salvador.

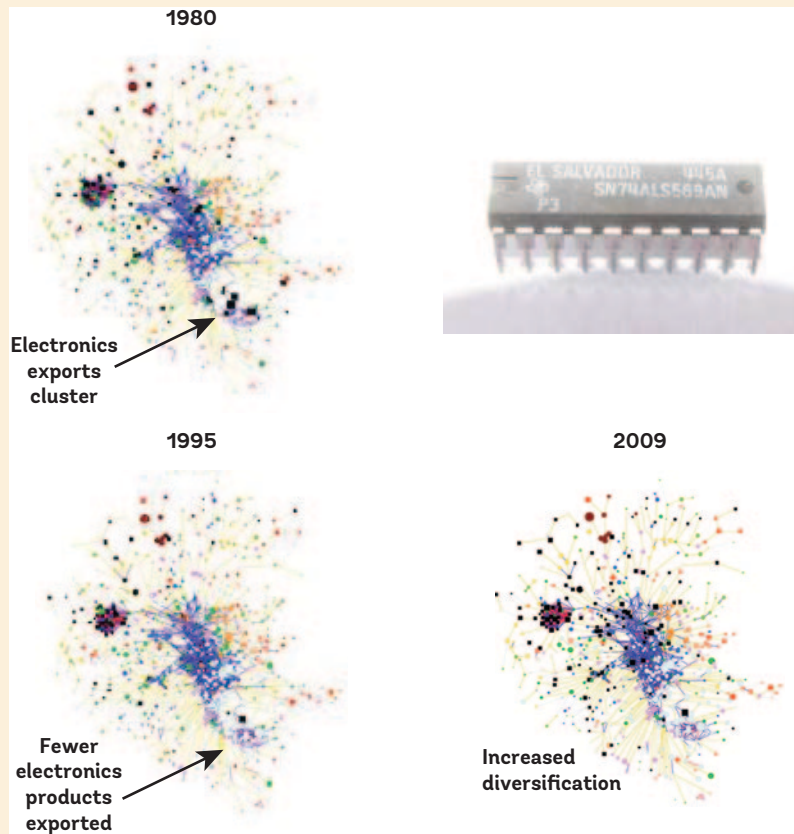
fibers suggesting a growing competitiveness of El Salvador in the plastics-synthetic fibers cluster. The planned introduction of natural gas through the Acajutla port, while primarily for power generation, also provides an opportunity to make available lower cost feedstock, further enhancing the competitiveness of this industry. While this analysis is not intended to be comprehensive it suggests that is realistic for El Salvador to build on existing strengths in its manufacturing base.

Available analyses suggest a number of manufacturing sub-sectors that are growing. Drawing on the “product space” and on an analysis of revealed comparative advantage and labor productivity by sector, Amaya and Cabrera (2013) suggest that there are in fact a number of clusters of economic activity that hold great potential for El Salvador (box 5.3). These include a broad range of activities, from

BOX 5.3 The Story of Texas Instruments in El Salvador (And the Almost Complete Loss of an Export Cluster)

Long before the arrival of Intel in Costa Rica another electronic leading firm of the day set its eyes in Central America. In 1973 Texas Instruments opened in El Salvador what would eventually become its most significant manufacturing plant outside the US. Texas Instruments was not alone. At its heyday in the late 1970s there were manufacturing plants for many other electronics companies, including IBM, Xerox, AVX Ceramics, and Dataram. The product space that maps the country's exports (denoted with black squares in the network of products shown in the right column of this box) shows that El Salvador had a significant presence in exporting electronics in 1980 (see figure B5.3.1). Electronics components, like the one pictured below, proudly displayed a reference to being made in El Salvador:

FIGURE B5.3.1 Exports in the Product Space



box continues next page

BOX 5.3 continued

The arrival of Texas Instruments to El Salvador followed the adoption of the 1974 Export Promotion Law, which provided for tax holidays, unrestricted repatriation of profits, guarantees against expropriation, and a specialized recruiting agency for laborers. Texas Instruments operated out of the San Bartolo Free Trade Zone and employed at its peak around 5,000 workers in two manufacturing facilities and drew on 300 local suppliers.

Like most other foreign firms, Texas Instruments closed its operations in El Salvador in the early- to mid-1980s due in part to difficult operating conditions in the midst of the civil war. In the first three years of the 1980s it is estimated that capital outflows exceeded \$1 billion. The promising electronics cluster did not survive. The product space for 1995 shows a much diminished presence in the exports of electronics, and indeed a significant reduction in the diversification of exports. While it is difficult to regain a footing in a rapidly evolving market such as electronics, and indeed the electronics sector has yet to make a comeback in El Salvador, the product space for 2009 shows a promising increased in the diversification of exports.

Sources: Bleakley 1984; Ibarra 2010; Amaya and Cabrera 2013.

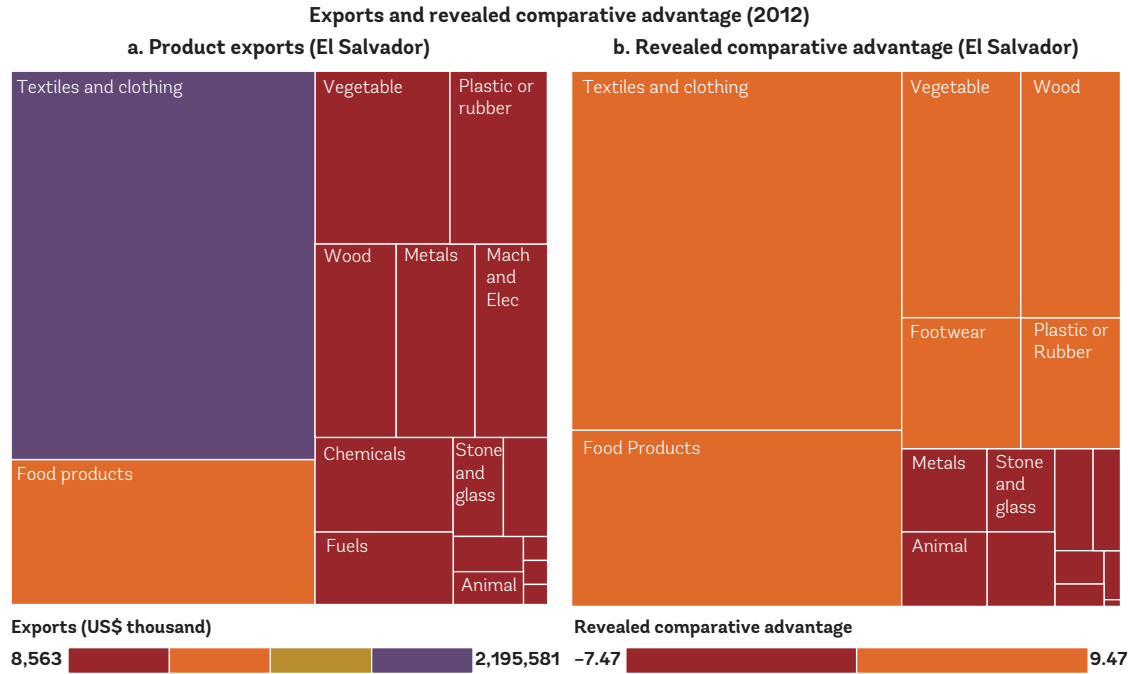
special aircraft and refrigerators to medicines, synthetic fibers, alcohol, and paint. Some pockets of El Salvador manufacturing are sophisticated enough to be able to export vaccines and hormones or to be part of global value chains that produce smartphones. Identifying specific bottlenecks that may be preventing further growth of these niches would be an important contribution of public policy.

And some of those sectors already show a revealed comparative advantage. While an analysis of revealed comparative advantage is necessarily backward looking it can help identify pockets where further export growth could materialize in the short-term. The

cluster around plastics, which was identified as high growth, is one such example where it has already reached the stage where it enjoys a revealed comparative advantage (see figure 5.7).

A number of successful firms have proven that the opportunities identified above can be realized. The strengths and opportunities highlighted above are not just theoretical. Box 5.4 below provides concrete examples of firms that have survived and thrived by making the most of the manufacturing base, of the Central American regional market, and of the geographic proximity and connectivity to large markets. These are firms that are generating skilled manufacturing jobs

FIGURE 5.7 In Sectors Such as Plastics There Is Already a Revealed Comparative Advantage



Source: World Bank.

BOX 5.4 Green Shoots—Selected Examples of Firms that Have Thrived

Making the Most of the Still Large Manufacturing Base

The sole survivor of the electronics cluster discussed in box 5.3 was a subsidiary of AVX Corporation. Founded in 1977, the plant in El Salvador manufactured passive electronic components, interconnection devices, and related products. It grew to become the largest employer in the local area with 1,600 employees in 1992 (up from 350 at the start of operations). With the help of MIGA to cover the risk of war and civil disturbance, the company continued expanding its production capacity during the 1990s, reaching 3,000 workers in 2010 and total annual sales of over \$120 million. The plant, still located in the San Bartolo Free Trade Zone, absorbed production lines of other AVX affiliates that were closed in Mexico and the Czech Republic when the holding company vertically integrated its production of capacitors. This case exemplifies how El Salvador can make the most of its still large manufacturing base.

box continues next page

BOX 5.4 continued

Making the Most of Regional Integration

Bon Appetit was established in 1982 by the Zablah family with the idea to export ethnic foods towards migrant workers in the US (a “nostalgic” market). Although nostalgic exports did not take off at that time the company survived through the 1980s by supplying the Salvadoran army. Trying to diversify its revenue sources, the company started experimenting with non-carbonated beverages and launched the bottled flavored drink called Frutsi, which was a success and prompted the opening of a new plant in La Libertad. The new plant allowed them to reach a packaging and royalty deal with Del Monte drinks.

With the opening up of the economy in the early 1990s the country lowered tariffs on imported goods, bringing in competition. The army contract ended and Del Monte changed its royalty agreement into a manufacturing agreement with reduced profit margins. The company needed to reinvent itself and raised \$2 million of equity through the sale of 30 percent of its shares to the Inter-American Investment Corporation (IIC), to upgrade its plant and the Gatorade sports drink for Quaker (which meant letting go of the food business lines). The company grew and increased its productivity by obtaining the permit for 12 hour shifts (which was seen as key to profitability and further growth).

In 2000 Quaker was bought by PepsiCo, opening the door for dialogue with the regional bottler Central American Bottling Corporation (CABCORP)—the preferred bottling partner of PepsiCo. CABCORP acquired 50 percent of the company in 2002 and expanded production capacity. The company continued to grow and began exporting large volumes to Guatemala, Honduras, and Nicaragua. After 6 years of increased product lines, CABCORP increased its ownership stake to 95 percent in 2009 (changing the company name to Livsmart). By being part of a larger company, Livsmart was able to face increasing competition, since in 2008 the Mexican Company Jumex inaugurated its state-of-the-art processing and bottling juice plant in El Salvador (\$20 million investment), from where it exports to over 20 countries and serves the Central America market. As the end of 2012, Livsmart generated 17 percent of all of CABCORP’s EBITDA, or approximately \$21.3 million, with sales of over \$130 million. It served markets in Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Panama, Puerto Rico, Haiti, the Dominican Republic, Mexico and United States (mainly south Florida and Texas).

Making the Most of Proximity to Large Markets

Aeroman is a company dedicated to the aeronautic maintenance, repair and overhaul (MRO) of airplanes (fuselage maintenance, not turbine maintenance). Its history is directly linked to that of TACA (now Avianca), which dates back to 1931 in Honduras. TACA was founded by New Zealander Lowell Yerex, with the idea of having a TACA

BOX 5.4 continued

franchise in each Latin-American country to provide air transportation services. After financial troubles, only TACA International based out of San Salvador remained, and which was sold to Howard Hughes in the mid-1940s and to the Kriette family of El Salvador. In 1985 the maintenance department of the company moved to El Salvador and created Aeroman to be able to operate locally. The company operated normally during the next five years servicing TACA's 7 planes but, in 1992, TACA signed a strategic alliance with Copa Airlines of Panama and subsequently took control of AVIATECA of Guatemala, LACSA of Costa Rica, and NICA of Nicaragua. This more than quadrupled TACA's fleet to 30 planes, and Aeroman needed to grow its service capacity. Aeroman built a new hangar in 1994 with the capacity of 4 bays (measurement of the capacity to service a plane at the same time, where 1 bay = 1 plane), in order to service TACA's fleet and leaving 25 percent of spare capacity to service third parties. By now Aeroman employed 700 highly skilled workers. In general terms, the highest cost of an MRO is the salary of its employees (70 percent), and the higher the productivity of its workers the higher the chances of getting new customers (since it will offer lower prices for its services).

The growth strategy worked and new clients were signed up for the maintenance service, taking advantage of the strategic geographic location of San Salvador's airport and in particular its proximity to the North American market. Despite the challenging market conditions after September 11, by 2003 the 4 bays were fully utilized. To continue growing Aeroman decided to find a partner with a world class reputation as an MRO. In 2006 Air Canada's Technical Services (ACTS) bought 80 percent of Aeroman for \$44.7 million and planned to invest \$110 million to expand capacity from 4 to 16 bays by 2016. Aeroman continued to add one additional bay per year, reaching 12 "production lines" by 2011. The results in El Salvador were phenomenal with over 2,300 employees and revenues of around \$120 million. In contrast Canada's operations of ACTS were struggling and Aeroman was put on sale. After a bidding process, the Kriette family bought back control of the 80 percent of Aeroman.

Demand for Aeroman's services kept rising and by 2014 all 12 bays were fully utilized. Once again Aeroman has new plans for expansion. The expansion will break new ground globally, since no single MRO worldwide has more than 12 bays in a single location. Besides the advantages of the proximity to the North American market Aeroman's expansion has been possible thanks to the well-functioning laws and regulations regarding the airport, the port authority, the tax exceptions for free trade zones (the airport being one of them), the excellent hand labor found in El Salvador, and a memorandum of understanding signed with government authorities to keep the operating environment as is. Future growth will likely depend on a reform of the Aeronautical Law that facilitates the entrance of new airlines and customers.

Sources: Interviews with Jorge Zablah, founder of Bon Appetit and Ernesto Ruiz, Chairman of the Board and ex CEO of Aeroman, AVX financial reports, Investment Policy Review El Salvador 2010 UNCTAD, MIGA, USDA Annual Update of Retail Food Report 2013/14, El Salvador Retail Foods, The Central American Bottling Corporation Offering Memorandum, May 23 2013.

and where labor productivity is often in the order of \$40,000 per year.

Prioritization

Approach to prioritization

The approach followed aimed to identify priorities to accelerate progress towards the goal of boosting shared prosperity. The prioritization is firmly anchored on a number of explicit criteria. First, the extent to which improvements in a given area would have substantial impacts on the twin goals. For example, the analysis in chapters 2, 3, and 4 explicitly considered how each of the topics analyzed affected the bottom 40. Second, this SCD also considered the time horizon of impacts, whether improvement in a particular area may be a precondition or complement progress in other areas. Finally, the prioritization also explicitly considered the strength of the supporting evidence and the feasibility of taking action, noting the difficulties in a number of areas (but not discounting an area as a priority for these reasons).

In identifying priorities the approach followed took into account a number of considerations particularly relevant in the case of El Salvador. Given the numerous challenges faced by the country an overly mechanical approach would risk missing important nuances and result in a simplistic list of priorities. In practice, the approach followed three key considerations, as follows.

First, given that the analysis identified the existence of self-reinforcing dynamics, entry points that could help break those vicious circles were identified as priorities. Building on existing strengths of the country was also considered here. The basis for this emphasis stems from taking into account

areas that complement progress in other areas. In the case of El Salvador this proves to be a critical aspect to derive priorities. This led to the identification of three areas where policy levers could help address the vicious circles: (a) strengthening violence prevention and law enforcement; (b) improving education and skills to compete; and, (c) improving productive services and financial inclusion.

Second, areas where improvement in a particular area may be a *sine qua non* condition for progress were also to be identified as priorities. Any effort to inform public discussion of the country's priorities would be remiss if it would obviate those areas where action needs to be taken to avoid significantly negative consequences. This led to the identification of the strengthening of the fiscal situation as a priority area.

Third, consideration was given also to structural issues that cut across and would complement progress in different areas. In some cases progress would be greatly enhanced if some structural changes could be enacted. By their very nature those changes would have a broad impact on a number of areas. This led to the identification of the importance of forging a political consensus to build a more transparent and efficient state and of improving the resilience of the country to disasters triggered by natural events as critical for sustaining progress.

The identified priorities were also informed by extensive consultations with stakeholders in the country. In terms of process the SCD has drawn on abundant background that has identified key constraints to economic growth, inclusion, and sustainability, and has undertaken consultations with stakeholders and experts in El Salvador.

Priorities—the need for a “big push”

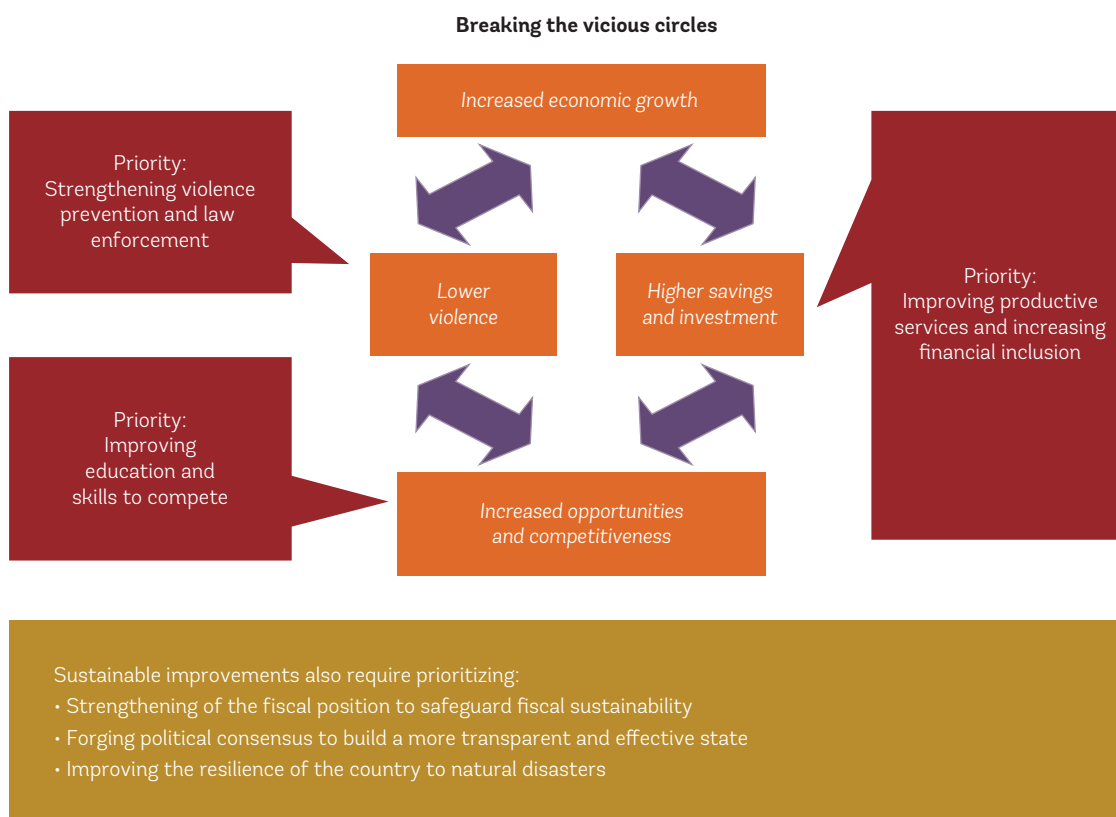
Breaking the vicious circles identified will require a “big push.” Marginal interventions are unlikely to help break the self-reinforcing dynamics that have kept El Salvador trapped in a vicious circle that links low economic growth, high migration, and high violence. Given the numerous challenges faced by the country a mechanical approach to identify priorities would miss important nuances and result in a simplistic list of priorities. In practice, the approach followed to identify priorities three key considerations. First, given the existence of self-reinforcing dynamics, entry points that

could help break those vicious circles were identified as priorities. Second, areas where improvement may be a sine qua non condition for progress were also identified as priorities. Third, consideration was given to issues that would complement progress in different areas. The rest of this section details the rationale for each of the areas identified as a priority in figure 5.8.

Strengthening violence prevention and law enforcement

The importance of strengthening violence prevention and law enforcement derives from the high social and economic costs imposed by crime and violence. The homicide

FIGURE 5.8 Priorities



rates in El Salvador since 2000 have been among the top 5 countries in the world; at 30 per 100,000 the homicide rate is five times the world average and had reached a peak of 60 homicides per 100,000 before a truce between gangs (*maras*) was agreed to in March 2012. The economic cost of this violence is very high, 11 percent of GDP annually including material losses, public and private security and health costs. The widespread availability of small firearms facilitated the expansion of violence. The *maras*, created among the Salvadoran migrant communities in the US, have further fueled violence as their members returned to El Salvador (either voluntarily or deported) and introduced to the country a criminal enterprise that lured the youth by providing a sense of identity. Today the *maras* count their members in the tens of thousands. This environment has been welcoming to drug trafficking. In addition to paying for private security costs, which are among the highest in the world, there is increasing evidence that fear of crime, and in particular extortions, prompts some businesses to exit from the marketplace altogether.

Significantly lower levels of crime and violence would impact positively economic growth, inclusion and sustainability. In terms of *impact on the twin goals*, the bottom 40 stands out as having the most to gain from a reduction in crime and violence since they are often the most affected by crime and violence. Lower crime and violence would imply that the costs of production fall as expenditures associated with buying protection are reduced. Smaller enterprises will gain the most in relative terms, with a potential positive impact on employment and hence inclusion. In addition, the drop in crime and violence may incentivize migrants to return

and in preparation for their return to invest, as in real estate. With more attractive opportunities, migrants can return to invest and transfer skills back. The drop in crime and violence can also be a boon for creating strong value chains, potentially contribute to an increase in exports, and open space for new areas of economic activity such as tourism. The reduction in crime and violence enhances social sustainability and improves the credibility and legitimacy of the state.

Addressing crime and violence would complement progress in other priority areas and help break the vicious circle from low growth to migration to low growth. Although data collection in this area could be improved the *evidence* that supports the link between crime and violence and the twin goals appears to be strong. Addressing crime and violence will support other priorities, in particular education, as fear of crime may be a factor that is behind the high drop-out rates. A strategy to reduce crime and violence is necessarily long-term and must target an enhanced accountability of government, greater transparency of the public actions to contain impunity and the strengthening of the judicial system. In the short to medium term, there are entry points around creating income and learning opportunities to steer the youth away from joining criminal organizations, providing incentives and skills for gang members to exit, and working with imprisoned populations to facilitate reinsertion into after they leave.

Improving education and skills to compete

Improving education and skills would positively impact growth, inclusion, and sustainability. Higher learning outcomes, even at

the current levels of attendance, would better equip the youth for the acquisition of skills necessary in the domestic market or in the markets where people migrate. A more educated and skilled population in the domestic market would alleviate the relatively high costs of labor. For migrants, it will represent better opportunities abroad, and possibly higher remittances into the country. Moreover, the country may follow an active policy of training migrants focused on skills that facilitate entry into selected labor markets abroad. It is also likely that improved educational outcomes contribute to the higher retention rates at the secondary level. Education is a key building block for other priorities, in particular reducing crime and violence.

A broad increase in educational outcomes would impact growth, inclusion, and sustainability. Higher learning outcomes, even at the current levels of attendance, would better equip the youth for the acquisition of skills necessary in the domestic market or in the markets where people migrate. A more educated and skilled population in the domestic market would alleviate the relatively high costs of labor. For migrants, it will represent better opportunities abroad, and possibly higher remittances into the country. Moreover, the country may follow an active policy of training migrants focused on skills that facilitate entry into selected labor markets abroad. It is also likely that improved educational outcomes contribute to the higher retention rates at the secondary level. Education is a key building block for other priorities, in particular reducing crime and violence.

The entry points to improve education have been amply studied and discussed. They include pre-school education, improving

teacher skills and capacity, measuring outcomes, introducing IT and English, and tailoring and expanding the existing vocational and training institutions to respond to the needs of the market. The diaspora could also provide trained personnel that fits the needs of the market—e.g., language skills.

Improving productive services and increasing financial inclusion

Reducing the high costs of productive services as well as reducing the regulatory burden on businesses will generate additional investment, employment and growth. First, in electricity the challenge is to reduce economic costs over the long haul and to diversify supply to reduce vulnerability. Local technology is available to increase geothermal supply, there is considerable potential for wind power, and installations that manage LNG can support increases in the supply of gas. Facing these challenges may require a review of the current regulatory environment. Second, in terms of connectivity, the bases are in place to generate rapid gains. The expansion of the airport in San Salvador will ease the pressure that has been building as the growth in demand is outstripping capacity. Greater competition in cargo transportation by road can reduce costs. Improving access to information technology infrastructure, such as broadband, could help make the most of the strong links that El Salvador has with large markets such as the US. Improvements in customs services are needed to facilitate trade within the Central American market.

Increasing financial inclusion can help raise savings and generate additional

investment. Although interest rates as quoted are low by regional standards, access to micro, small and medium enterprises is constrained, limiting the expansion of these employment intensive sectors. In addition, the low level of use of the banking services by the population represents penalizes savings with serious micro and macro consequences. While this is an area where the evidence base is mixed, given the great potential of tapping into the large remittance flows, it is considered to be a priority for boosting shared prosperity in the country.

But sustainable progress will also require prioritizing:

- Strengthening of the fiscal position to safeguard fiscal sustainability
- Forging political consensus to build a more transparent and effective state
- Improving the resilience of the country to natural disasters

Strengthening of the fiscal position to safeguard fiscal sustainability

Public debt sustainability hinges mainly on sustaining fiscal discipline and strong economic growth. El Salvador's challenge is to stabilize and eventually reduce its debt level to create much needed fiscal space for growth and poverty reduction purposes and keep financing requirements manageable. While growth plays a key role in ensuring the sustainability of the fiscal position, reforms are needed to avoid further deterioration of the debt ratios. Fiscal adjustments will require measures to increase revenue, reduce/reassign expenditures, and improve public

expenditure management as well as debt management.

Strengthening the fiscal position is a prerequisite for further progress. Fiscal deficits and slower economic growth since the global crisis have increased public debt. Public debt relative to GDP went from 40 percent in 2008 to 58 percent in 2013. There are no immediate concerns about debt sustainability, but continuing the growth and fiscal trends of the recent past would increase the debt to GDP ratio up to 70 percent in 2019. So stabilizing debt levels will require fiscal adjustment between 1.5 percent and 3.5 percent of GDP depending of the target level for the public debt. The most significant fiscal issue now are the management of the pension debt issued as the country transitioned from a defined contribution system and improving the targeting of subsidies in electricity, gas, water and transport. The current environment of low oil prices may provide an opportunity to address subsidy reform. A higher rate of economic growth would alleviate the fiscal difficulties, finance priority expenditures and investments, and boost the income of the bottom 40. At the same time, there is scope for mobilizing additional tax revenues—which at around 15 percent of GDP remain comparatively low.

Forging political consensus to build a more transparent and effective state

The limited capacity of the state stands as a major constraint to growth, employment and poverty reduction. Inadequate institutional designs favor opaque practices that hide objectives, designs and outcomes. The lack of transparency limits efficiency and

prevents the dialogue and analysis to improve them. Bringing about desired institutional transformations will take time, but immediate actions in selected areas can trigger the process of reform. First, the rationalization of subsidies, such as in electricity, that have had a negligible impact on the reduction of poverty will favor inclusion and foster fiscal strength. Similarly, addressing the growing pension debt originating in the particular way in which the country transitioned from a defined to a contribution system will help consolidate the fiscal position. Second, improving access and quality to health and education services will help especially the bottom 40, which lags behind in access to basic opportunities. Third, given the limited public resources from now to the medium and long haul, careful prioritization of public investment with an eye on the impact on development outcomes is required. In addition, the government can develop a strategy and build the capacity for engaging the private sector in selected infrastructure projects. Lastly, greater transparency of the public sector, including budgetary actions and outcomes, can help build the credibility of the state and enhance the sustainability of basic institutions in the country.

A weak state has also been unable to contain and reduce the impact of crime and violence. Impunity prevails as the criminal conviction rate is less than 5 percent. Police and judiciary are widely perceived as corrupt and the Supreme Court has the lowest level of citizen confidence among major public institutions. Private security expanded to fill the vacuum; Enterprise Surveys suggest that firms spend 3.4 percent of sales in protection, amongst the highest percentages in the world. The quality of public institutions has

remained stagnant, which has not helped to build trust among the citizenry. In addition, the difficulty of the state in providing security has exacerbated a lack of trust by the citizens in public institutions. The weakness of the state shows also in its limited capacity to mobilize internal revenues and spend them effectively.

Underlying the limited effectiveness of the state is a highly polarized political arena where limited consensus is the norm. The political polarization and mistrust prevent agreement across the board on critical national priorities. The country for example has been slow to respond to the threats to its industry and exports from Asian competitors. The rising threat from crime and violence, while widely acknowledged as extremely damaging across the board, has not coalesce countervailing forces to keep the threat at bay.

Improving the resilience of the country to natural disasters

Moving from a reactive to a preventive approach to disaster risk management will lower social and economic costs of disasters. El Salvador is also one of the countries in the world that is most affected by weather-related events and other natural hazards. Combined, El Salvador incurs annual losses of around 2.5 percent of GDP due to natural disasters. These losses add to fiscal pressures and constrain wealth accumulation. Climate change is expected to increase the frequency and severity of the weather-related events.

The government can complete adopting mechanisms to finance responses to disaster, through insurance or contingent funds and improving the administrative capacity

to respond. In addition risk reduction and mitigation measures could be enhanced. Improving resilience to disasters will also require improving the quality of housing and basic services in urban areas and addressing environmental degradation. Over the long haul, the challenge is to introduce and enforce the appropriate guidelines for the construction of buildings, the location of business and populations, and the uses of land.

In conclusion

El Salvador has the potential to boost shared prosperity. To do so it can build on some

strengths and opportunities available to the country, including making the most of the large flows of remittances, its geographic and cultural proximity to large nearby markets, the ongoing process of regional integration, and an existing manufacturing base. At the same time, it must be recognized that progress will not be easy. El Salvador's predicament is being stuck in a low growth trap, in which migration and low growth reinforce each other through a variety of vicious circles. The priorities identified in this systematic county diagnostic are mindful of this and therefore focus on efforts at breaking out of such state of reinforcing stagnation.

Notes

1. For a longer discussion of these issues see World Bank (2012a).
2. These results, however, may be outdated as banks have increasingly expanded access to loans and other financial tools for

consumers receiving remittances. More recent research in other countries finds causal evidence that remittance receipt leads to more consumer debt (Ambrosius and Cuecuecha 2014).

Appendix A: Poverty and Shared Prosperity: Measurement Issues

SINCE 1992, EL SALVADOR has conducted the *Encuesta de Hogares de Propósitos Múltiples* (EHPM), a continuous survey from January to December of each year. This survey includes data on income and consumption. The sampling frame changed in 2003. Currently, the survey has national coverage and is representative for El Salvador as a whole (distinguishing between urban and rural areas), regions (also by urban and rural areas), and departments. With the new sampling frame it is possible to calculate indicators for the country's 50 main municipalities. In 2007, results were further adjusted to the new Census and, as of 2008, the sample frame is based on the newest *Censo de Población y Vivienda* (2007).

Although El Salvador introduced the U.S. dollar as its official currency in 2001 (with a fixed exchange rate of 8.75 colones per dollar), surveys continued to be conducted and published in colones until 2003. For the current analysis, data previous to 2004 were

converted to dollars using the exchange rate of 8.75 colones per U.S. dollar. The survey allows two different welfare aggregates to be constructed, one based on income and one based on consumption. This document's main results rely on an income aggregate. To enable comparison across time, income has been converted to constant prices of 2000, which is the base year for the Consumer Price Index (CPI).

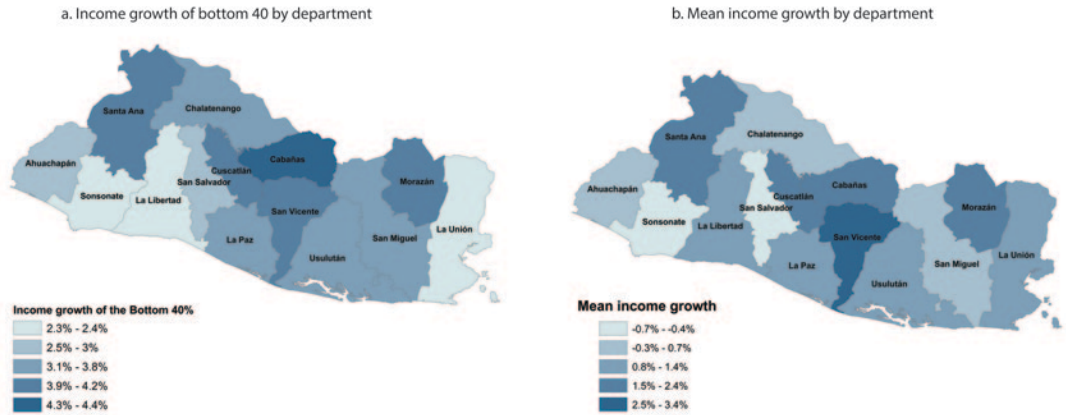
El Salvador's official poverty lines use different consumption baskets for urban and rural areas. The cost of these food baskets is updated annually, and the overall poverty line is twice the extreme (food) poverty line. The General Directorate of Statistics and Censuses (Dirección General de Estadística y Censos, DIGESTYC) relies on income to calculate poverty and presents results by households. The value of the poverty line at the household level is the value of the individual poverty line multiplied by the average size of the household in each year (table A.1).

TABLE A.1 Nominal Value of the Poverty Lines (US Dollars)

	Per household			Per capita		
	2000	2005	2010	2000	2005	2010
<i>Total</i>						
Urban	256.5	273.1	336.6	63.6	70.6	90.2
Rural	197.0	175.1	236.8	40.8	39.2	55.6
<i>Extreme</i>						
Urban	128.2	136.5	168.3	31.8	35.3	45.1
Rural	98.5	87.5	118.4	20.4	19.6	27.8
<i>Average household size</i>						
Urban	4.0	3.9	3.7			
Rural	4.8	4.5	4.2			

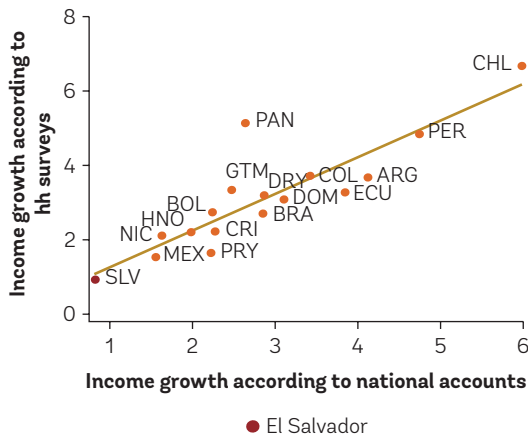
Source: Dirección General de Estadísticas y Censos de El Salvador (DYGESTIC).

MAP A.1 Growth of Income of the Bottom 40 and Mean Income by Department



Source: World Bank staff calculations based on EHPM.

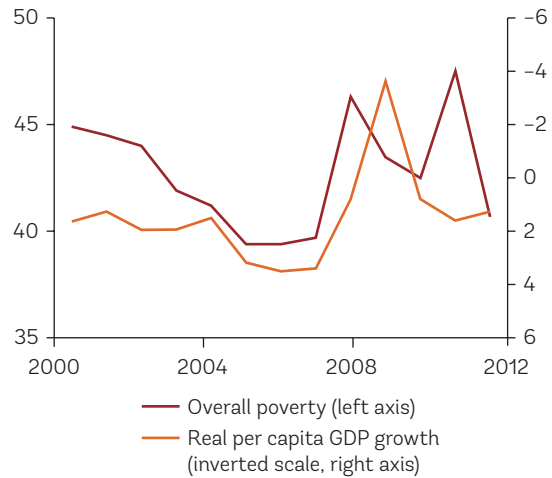
FIGURE A.1 Income Growth from National Accounts (GNI) and Household Surveys, LAC



Source: World Bank staff based on SEDLAC.

The value of the line at the per capita level is not publicly available: some numbers in table A.1 were calculated by the authors using the value of the poverty line at the household

FIGURE A.2 Poverty and Growth Rates, Percent



Source: World Bank staff based on EHPM.

level and the average size of the household. Estimations presented here are at the individual level and thus differ from official estimates.

Appendix B: Additional Material

FIGURE B.1 Volatility and Average Growth in Latin America and the Caribbean Countries, 2001–13

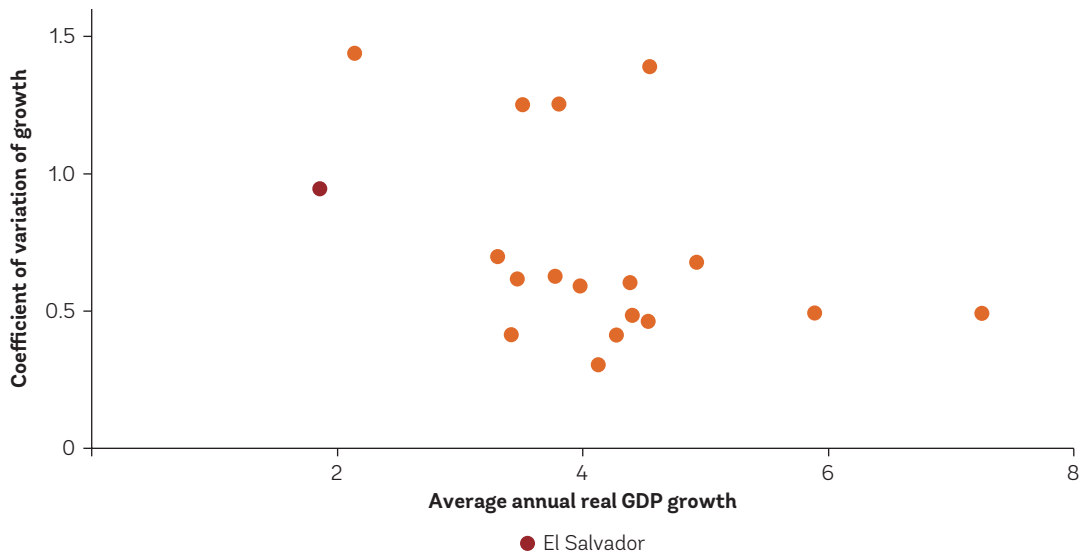


FIGURE B.2 Average Real GDP per Capita Growth (2011–13) Compared to Lower Middle Income Countries

Percent

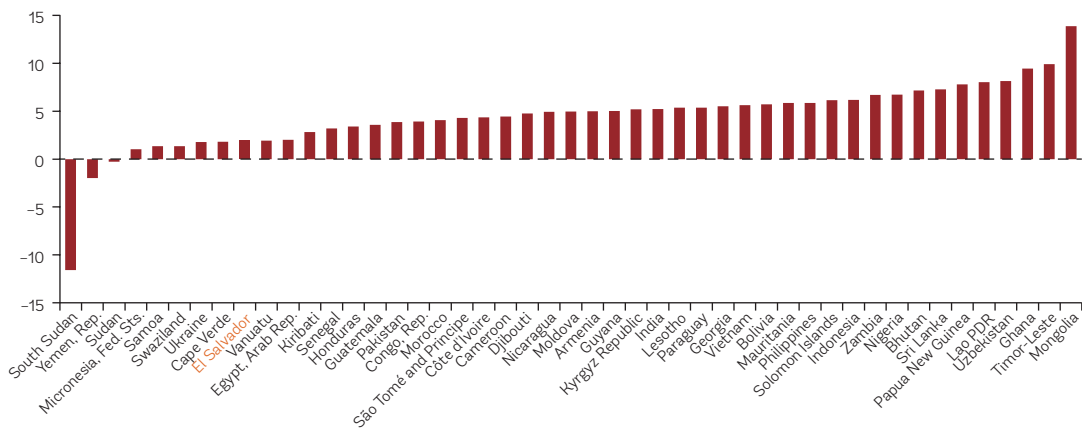
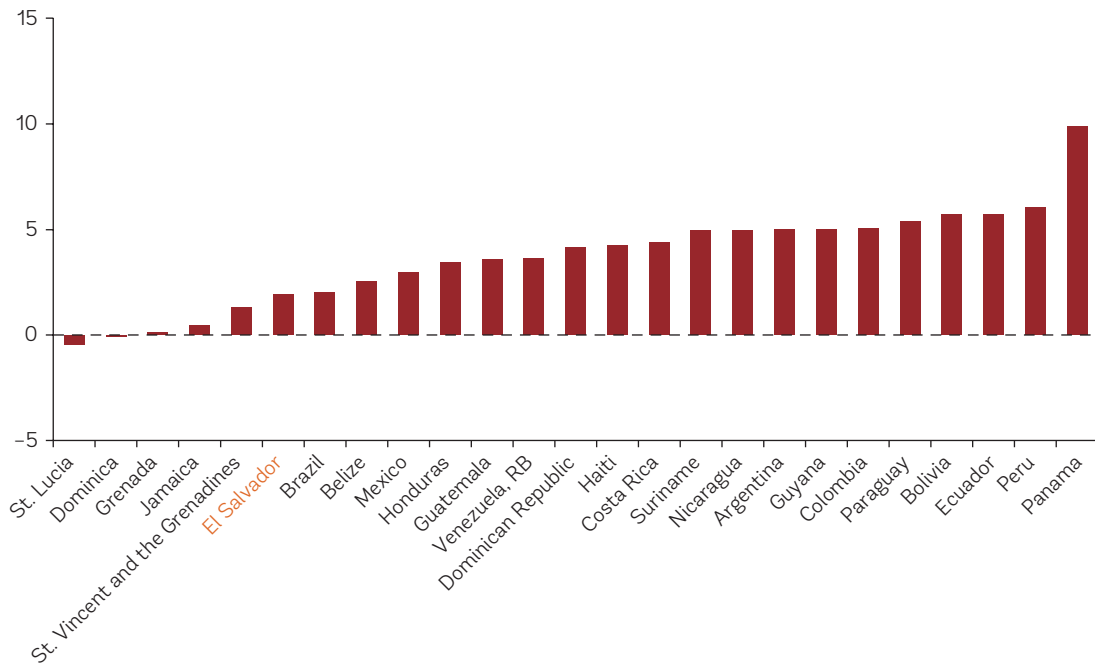


FIGURE B.3 Average Real GDP per Capita Growth (2011–13) Compared to Latin America and the Caribbean Countries

Percent



Source: World Bank.

FIGURE B.4 Value Added by Sector

Percent

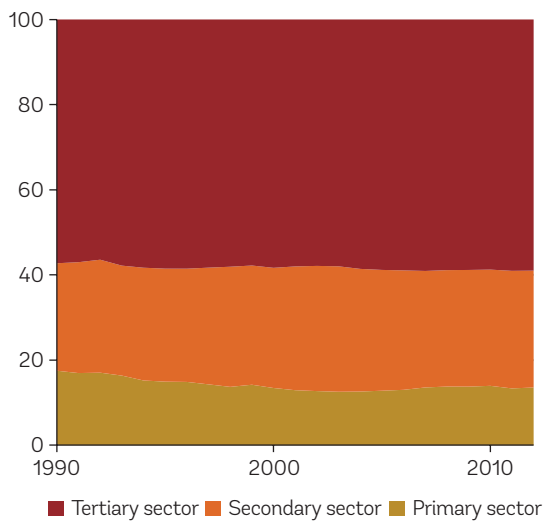


FIGURE B.5 Employment Added by Sector

Percent

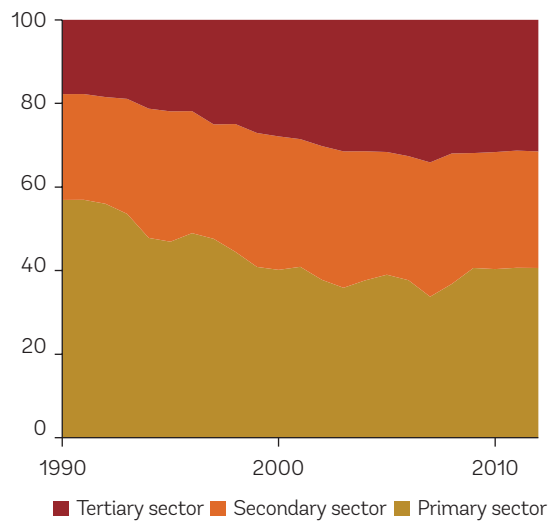
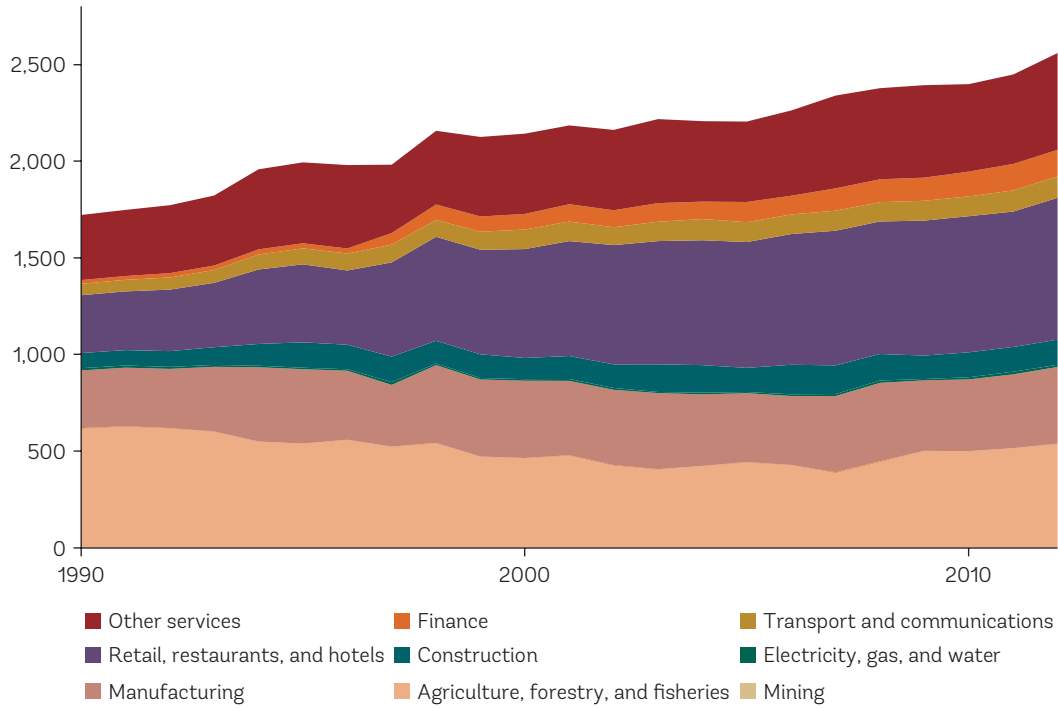
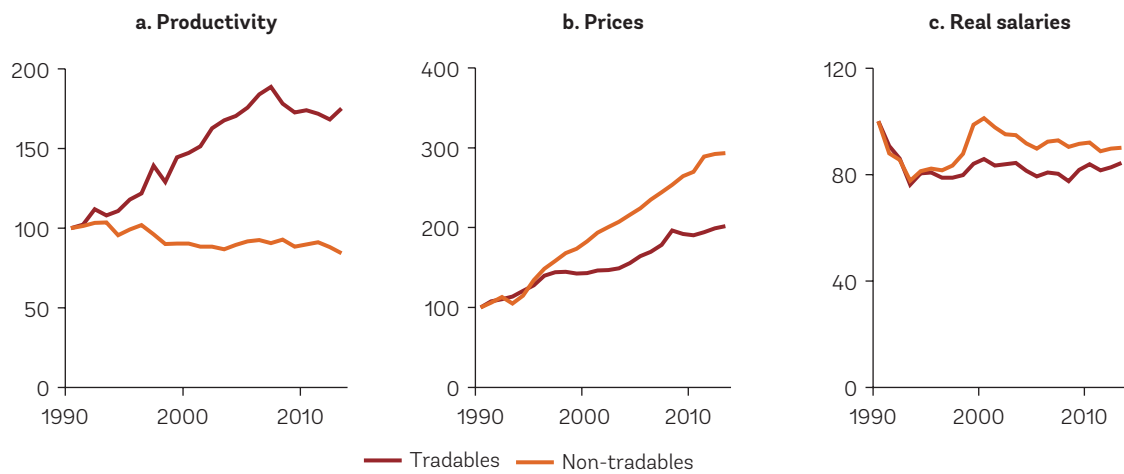


FIGURE B.6 Value Added by Sector
Percent



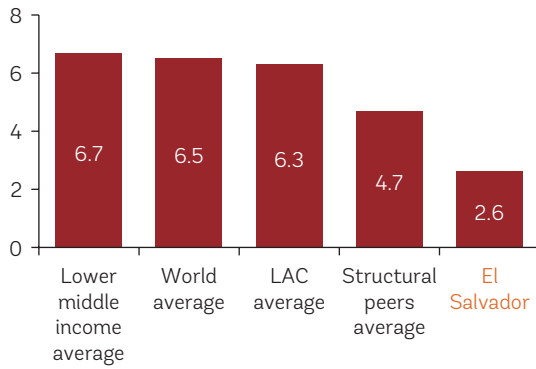
Source: Central Bank of El Salvador.

FIGURE B.7 Comparison of Tradables and Non-Tradables Sectors (Indices, 1990 = 100)



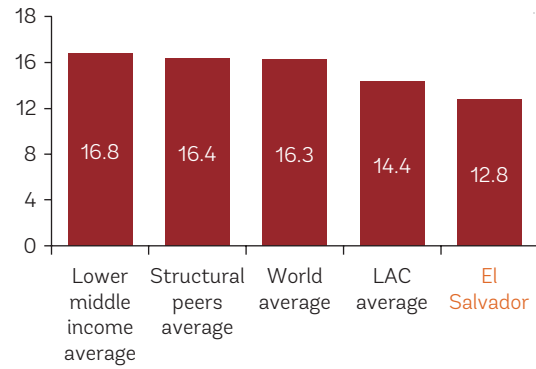
Source: Cabrera 2014.

FIGURE B.8 Gross Fixed Public Capital Formation, Percent of GDP, Average 2000–13



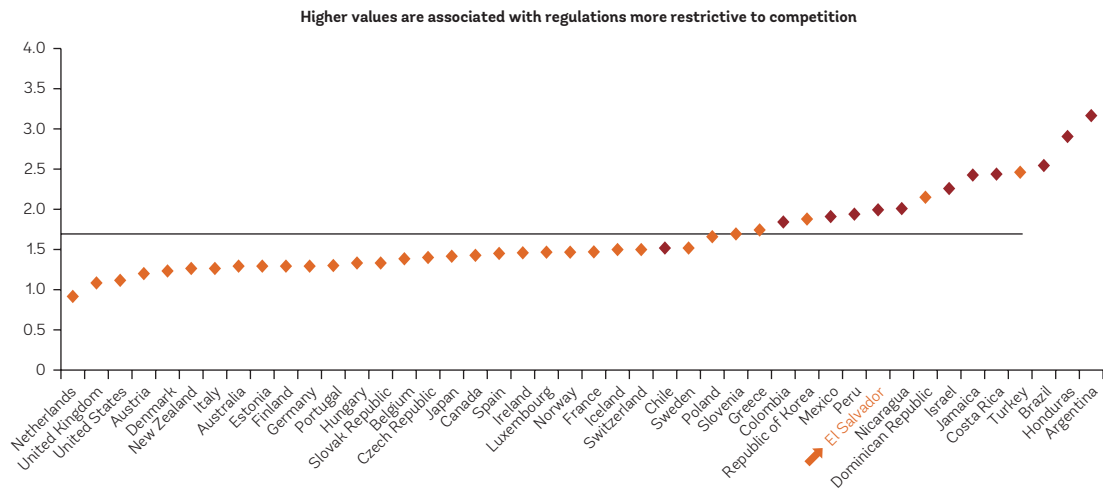
Source: World Bank.

FIGURE B.9 Gross Fixed Public Capital Formation, Percent of GDP, Average 2000–13



Source: World Bank.

FIGURE B.10 OECD Product Market Regulation Indices



Source: World Bank.

FIGURE B.11 School Enrollment by Age and Gender



Source: World Bank.

TABLE B.1 Standard Deviation of GDP Growth and Output Gap

	Standard deviation of GDP growth		Standard deviation of GDP gap	
	1960–99	2000–11	1960–99	2000–11
El Salvador	4.7	1.8	5.2	1.9
LAC average	4.7	3.2	4.7	3.2
Lower middle income average	1.6	1.5	1.4	1.5

TABLE B.2 Selected Social Sector Indicators

	El Salvador		LAC 7	
	2000–05	2006–11	2000–05	2006–11
Education				
School enrollment, preprimary (% gross)	49.8	60.2	66.1	82.2
School enrollment, primary (% gross)	109.1	114.4	113.2	113.2
School enrollment, secondary (% gross)	58.6	63.5	79.1	86.5
School enrollment, tertiary (% gross)	20.8	22.5	30.7	45.3
Primary completion rate, total (%)	82.9	92.3	99.1	103.7
Pupil-teacher ratio, primary	45	34.7	24.8	23
Health				
Pregnant women with prenatal care (%)	86	94	92.2	96
Undernourishment (% of pop)	9.9	11.8	11.7	9.6
Immunization, measles (% 12–23 m)	94.5	94.7	94.9	94.9
Improved sanitation facilities (% of pop)	84	86.6	80.4	83.5
Improved water source (% of pop)	84	87	91.4	93.4
Hospital beds (per 1,000 people)	0.9	0.9	2	2.1

table continues next page

TABLE B.2 *continued*

	El Salvador		LAC 7	
	2000–05	2006–11	2000–05	2006–11
Social protection				
Employment to population, 15+ (%)	55.8	57.1	58.3	60.6
Labor force participation, female (%)	47.6	49.6	52.8	56.1
Unemployment, total (%)	6.8	6.5	9.8	7.8

Source: World Bank 2015a.

Note: LAC 7 = Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.

TABLE B.3 **Selected Infrastructure Indicators**

	Urbanization rate (2013)	Telecom access (per 100 people, 2013) ^a	Electricity access (% of pop., 2011)	Access to improved sanitation (% of pop., 2012) ^b	Access to improved water (% of pop., 2012) ^c	Total road network (km per 1,000 people) ^d	Paved roads (%., 2011) ^e
El Salvador	66	151	92	87	88	1.2	53
LAC average (unweighted)	67	130	89	79	91	5	29
Argentina	91	182	97	97	99	6	32
Bolivia	68	106	87	46	88	8	12
Brazil	85	158	99	81	98	8	14
Chile	89	152	..	99	99	4.5	24
Colombia	76	119	97	80	91	4.6	..
Costa Rica	75	166	99	94	97	9	26
Dominican Republic	77	100	96	82	81	..	..
Ecuador	63	127	96	83	86	3.1	..
Guatemala	51	152	82	80	94	1.1	45
Guyana	28	89	..	84	98	..	..
Haiti	56	70	28	24	62	..	..
Honduras	54	104	83	80	90	..	..
Jamaica	54	109	93	80	93	8.2	73
Mexico	79	103	..	85	95	3.1	38
Nicaragua	58	117	78	52	85	4	13
Panama	66	178	88	73	94	4.1	42
Paraguay	59	110	98	80	94	4.9	16
Peru	78	109	90	73	87	4.4	13
Trinidad and Tobago	9	167	99	92	94	..	..
Uruguay	95	185	99	96	100	..	..
Venezuela, RB	89	127	100	91	93	..	..

Sources: World Bank (Infrastructure for Sharing Prosperity in Latin America and the Caribbean, Regional Studies Series, under preparation). Data for water and sanitation for El Salvador from MAPAS (2014).

Note: .. = negligible.

a. Telecom Access is defined as the number of fixed and mobile lines.

b. "Improved Sanitation": connection to a public sewer, a septic system, pour-flush latrine, simple pit latrine, and ventilated improved pit latrine. Data for El Salvador from 2010 and for República Bolivariana de Venezuela from 2007.

c. "Improved Water": household connection, public standpipe, borehole, protected dug well, protected spring, rainwater collection. Data for El Salvador from 2010, for Trinidad and Tobago from 2011 and for República Bolivariana de Venezuela from 2007.

d. Data for Ecuador from 2007.

e. Data from Jamaica from 2005.

MAP B.1 Map of El Salvador



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SINCE THE END OF THE CIVIL WAR IN 1992, El Salvador has advanced on both the social and political fronts. Despite this progress and the recent reductions in income inequality, poverty remains high, largely as a result of low economic growth. This Systematic Country Diagnostic argues that the challenge in El Salvador is not to identify the proximate constraints to growth, but how those constraints are inter-connected and what entry points may help break what can be characterized as “vicious circles.”

The Systematic Country Diagnostic identifies three inter-connected vicious circles that hamper growth and shared prosperity: (1) a cycle of low growth and violence; (2) a cycle of low growth and migration; and (3) a cycle of low growth, savings and investment. Moreover, it also notes action on the identified entry points will require a “big push” (rather than marginal interventions) that helps break the existing development dynamics. But this Systematic Country Diagnostic also identifies some strengths that El Salvador could build on to propel growth. Areas of opportunity include migration with the positive impact of diaspora on development, geographic and cultural proximity to large export markets, particularly the U.S., and an industrial base that can support an expansion of the tradable sector. At 20 percent of GDP, the manufacturing sector is large by Latina American and by middle-income country standards.