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EL SALVADOR'S ECONOMY SPUTTERS AND U.S. AID POLICIES ARE THE CULPRIT

INTRODUCTION

U.S. financial aid is pouring into El Salvador at the rate of almost $1 million per day. Since 1980, that country has received nearly $1 billion to reform and modernize its political, economic, and military systems. This U.S. aid aims at bolstering democracy and defeating the communist insurgency in El Salvador. There has been important progress in these areas. Yet El Salvador recently has begun showing the strains and weaknesses of a developing country growing too dependent on U.S. aid.

This growing dependency is the result of poorly conceived U.S. aid packages presented to an inexperienced government that, in truth, is seeking to design socialist-style programs and construct a socialist-style economy. As is typical of government-to-government transfers, economic decisions have become politicized. The result: inefficient state-run projects, such as the land reform cooperatives and a host of state-run industries that are structurally incapable of generating wealth, jobs, or lasting standard-of-living gains for most Salvadorans. Production levels of such major industries as coffee and sugar have decreased dramatically--a fact attributable more to the government's regulations and high taxes than to the disruptions of an ongoing guerrilla war.

As the Salvadoran economy falters, U.S. aid then becomes no more than a band-aid, used for programs to cover balance-of-payment deficits, bad debts, shortfalls, and the financial burden of agrarian reform. By propping up the economy in this way, regrettably, the U.S. perpetuates faulty economic policies and ensures that El Salvador's need for aid will increase. This use of U.S. aid also allows the

Salvadoran government to avoid the hard economic choices needed to resuscitate a stagnating economy.

In place of these programs, which are failing El Salvador and the U.S., Washington should inaugurate a new aid strategy, based on contracting with Salvadoran private sector organizations. U.S. money should go to small, local business groups, who would then use it to carry out specific projects. The continuance of U.S. aid would be tied to specific results and completion of the designated project. The immediate targets of restructured U.S. aid should be the inefficient and wasteful land reform programs and the stifling government monopoly over major exports such as coffee and sugar that are destroying El Salvador's once thriving agricultural sector.

In addition to financial help, the U.S. should provide El Salvador with expert advice concerning the improvement of the country's judicial system. This is critical for the protection of private property rights and the free flow of commerce. And Washington also must reconsider its support for the International Monetary Fund-style austerity measures now being forced upon the Salvadoran government in full consideration of the IMF's record elsewhere and of the Salvadoran government's contradictory policy of raising wages and fixing prices.

A new approach is needed for U.S. aid to El Salvador. U.S. programs and technical assistance should be designed to encourage a self-sufficient, prosperous productive sector. To achieve these goals and reduce the country's economic dependence on the U.S., aid should be given only on condition of El Salvador's adoption of market-oriented policies that lead to growth through private sector development and foreign direct investment.

The Salvadoran government must be urged strongly to reduce its substantial involvement in the country's economy. The U.S. can best promote this by steadily reducing the amounts of U.S. funds that go directly to the government and channeling them instead to the private sector. In addition, the U.S. should encourage lower government taxes on the productive sector, particularly on its major export, coffee. Inefficient government monopolies should be phased out and subsidies eventually reduced or eliminated. Finally, as in the case of human rights, respect for individual civil, and property rights should be a condition for continuing U.S. assistance, since without such safeguards no economy can prosper.

THE BASIS OF CURRENT DIFFICULTIES

During the 1960s and part of the 1970s, the economy of El Salvador, as in other Central American countries, grew rapidly, mainly because of the free trade policies between the Central American countries, high world prices for their major exports of coffee, cotton, and sugar, and unhampered foreign direct investment. In the late 1950s, Central American countries were promoting regional economic integration based upon free trade with each other. By 1970, manufacturing represented as much as 18 percent of El Salvador's Gross Domestic Product, compared with 13 percent for all of Latin America.

When foreign investment was encouraged, many corporations, mostly from the U.S., invested in the region. Such direct foreign investment rose from 16 percent of GDP in 1960 to 26 percent in 1978, and it allowed Central American countries to expand small industry without having to borrow great sums from Western banks. During this period at least, Central America avoided the heavy debt burden that many Latin American countries were assuming. From 1960 to 1970, El Salvador was economically self-sufficient, and U.S. economic aid totaled only $7 million.

Through the early 1970s, El Salvador maintained a 6 percent growth rate, but then was hit hard by the oil crisis in the mid-1970s and the subsequent world recession. The rapid increase in oil prices in 1973, and especially in 1979, triggered inflation. Rapid changes in price levels discouraged both domestic and foreign investment. The world recession at the end of the 1970s drastically reduced prices for Central America's coffee, cotton, and sugar exports. By 1981 economic growth had halted. Regional economic integration had begun to unravel. In El Salvador, of course, deteriorating economic conditions were aggravated by increasing political strife and an armed conflict.

The period of rapid economic growth slowly altered El Salvador's traditional social and economic structures, as many Salvadorans moved into the urban areas to work in the small factories and agriculture became more mechanized. A small middle class, meanwhile, was emerging, which no longer complacently accepted the existing political and economic order dominated by the very wealthy. This middle class, together with newly organized labor, began exerting pressure on the status quo.

Increasing terrorist violence by both the far left and far right, the spreading desire for economic and political change, and the Marxist-Leninist takeover in neighboring Nicaragua prompted reform-minded army officers in 1979 to overthrow the government of General Carlos Humberto Romero. Eventually Jose Napoleon Duarte, a leader of the reformist Christian Democrat Party, agreed to become provisional president. Duarte had been out of the country since 1972 after an election he apparently won was altered in favor of the military. His government quickly began carrying out extensive economic restructuring through land reform and the nationalization of the export and financial sectors. These reforms, which included preparations for democratic elections, were strongly backed by the Carter Administration.

ECONOMIC DEVELOPMENTS AFTER 1979

These economic reforms polarized political factions and for several years engendered considerable violence, but these problems began to subside as confidence in the democratic process grew. And since the 1982 Constituent Assembly elections followed by presidential and congressional elections, El Salvador has achieved even greater political and social stability. The more stable political environment should have improved conditions for economic growth. But 1984 saw only 1.5 percent growth, and last year the economy weakened further.[1]

Gross domestic product now is 77 percent of what it was in 1978, because of negative growth rates between 1979 and 1982 and near zero growth rates since then, and per capita income has fallen to 68 percent of 1978 levels. The industrial sector is currently operating at less than 77 percent of capacity. Unemployment is estimated at 40 percent and underemployment at 60 percent. Until January 21, 1986, when the currency was fully devalued, inflation was running at 22 percent.

Increased amounts of U.S. aid have helped avert an economic collapse in El Salvador. Although some U.S. funds go toward development projects and humanitarian aid, most U.S. aid is targeted for economic stabilization through balance-of-payments support. Last year, for example, the Agency for International Development's (AID) program summary showed that, out of total U.S. aid of $372,755 million, $255 million was to offset the balance-of-payments deficit. For next year, AID is requesting that $207 million out of the total U.S. aid of $325 million be used to support the country's deficit.[2]

The figures convey one message: El Salvador's economy is not improving despite huge amounts of foreign aid, and thus the country has no impetus to become self-sustaining. While some of El Salvador's economic decline can be attributed to the armed conflict and guerrilla disruption of the country's infrastructure, most of the blame,

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1. The 1984 slight increase in GDP growth was supported by continued growth in U.S. economic assistance and favorable weather for crop production. Real economic growth per capita, however, fell during this time. Foreign Economic Trends, El Salvador, U.S. Department of Commerce, November 1985.

2. Higher world prices for coffee and Gramm-Rudman foreign aid cuts account for the slightly lower aid request.

according to IMF and independent auditors, lies with the Salvadoran government's socialist economic policies.[3] These policies include:

Export Policies

Since the export sector was nationalized in 1980, coffee has played a major role in transferring wealth from the private to the public sector. Coffee accounts for about one-half total exports and is sold by the growers to the government agency, INCAFE (National Coffee Institute). There, bureaucrats determine the price to be paid the growers for the latest crop and then sell the coffee on the world market. The government, of course, benefits from the difference between what it pays the growers and what it receives on the external market. This spread has widened in the past three years. Today the growers are paid less than it costs them to cultivate coffee.

Duarte uses coffee revenues to subsidize government programs and the economy. This January, he explained in a nationally televised address that "coffee does not belong only to those who grow it, but to the entire nation." This followed the government announcement that it would be paying growers $80 a quintal (a 100-pound bag) for coffee, despite the fact that world prices had soared to $250 because of Brazil's bad crop. To make matters worse for the growers, they must pay a tax on the amount of coffee that is exported. This year the tax climbed to 45 percent from 30 percent.

The government is notoriously slow in paying the growers for their coffee. Payments are sometimes delayed for a year. A new government policy promises to pay the growers in five installments within one year. But it is still difficult for the growers to cover their hefty early season expenses for fertilizer, coffee plants, and capital improvements. Many growers, in need of capital, have resorted to illegal trading with Honduras and Guatemala.

The result of these government policies has been predictable: increasingly lower production levels. While coffee production rose 50 percent from 1975 to 1980, since then it has dropped 50 percent. Causes of this include lack of maintenance and replanting, coffee rust disease, and depressed world market prices. In the past year alone, coffee production fell from 3.5 million to 2 million quintals. Destruction of crops by leftist guerrillas has not been a factor.

Lower production has destroyed jobs. Unemployment is up to 40 percent from 30 percent last year and 27 percent in 1982. Underemployment is also severe, since many of the coffee laborers can

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3. Arthur Young & Company, "Review of Foreign Exchange Allocation and Control Procedures," Final Draft, February 1985; and IMF Staff Report for the 1985 Article IV consultation with El Salvador.

only find part-time work. Salaries have not increased in five years because of the shrinking or nonexistent profits of the coffee growers. As inflation has mounted and employment fallen, living conditions have worsened dramatically. Example: wages have remained frozen while the cost of living increased 120 percent between 1981 and 1986.

The decline of coffee production casts a long shadow across El Salvador's economic and political future. Few coffee trees have been replanted in recent years. Yet at least 5 percent of the trees must be replanted each year if production is to be maintained. Since these trees take at least three years to mature, this neglect will not be fully felt until the late 1980s. What is already felt is the $77 million drop in tax revenues and the $257.2 million drop in foreign earnings because of falling coffee production. And as the standard of living decreases for the peasants and the nearly 40,000 small coffee growers, the possibility increases for the breakdown of El Salvador's fragile political consensus.

Land Reform

Considered to be one of the most far-reaching programs in the region, the 1980 land reform effectively transformed El Salvador's agricultural sector. The first of three phases or programs for reform converted the 100 largest estates into about 400 cooperatives for almost 50,000 families, many of them full-time workers on the farms. In this first phase, the government retained title to the lands. Phase II, incorporated into the 1982 Constitution, has not been initiated. It would affect 17,000 medium-sized estates. Owners would have to sell holdings in excess of 24,566 acres. Phase III, designed and promoted by the U.S. government, aimed to make every Salvadoran tenant and sharecropper owner of the land he tilled. Sixty-four thousand beneficiaries were able to claim up to 17 acres. Phase III affected 30 percent of all cropland, of which most was medium-sized farms owned by farmers of moderate means.

By economic criteria, the land reforms are failing. Most of the cooperatives are in debt, borrowing heavily each year to cover costs that their harvests cannot support. The cost of debt service thus grows each year while the profits diminish or remain static. Production levels, despite enormous infusions of financial aid from U.S. AID and the Salvadoran government agricultural development banks, are lower than those of existing privately owned farms. The main cause of this is the lack of individual incentive to produce and manage well. Because the peasants do not own their land, their farms' earnings go directly to the notoriously corrupt and inefficient government land reform agency (ISTA), which then decides how the earnings will be distributed among all the cooperatives. ISTA determines also how the money will be invested and spent. Requests by the peasants to buy their plots have been denied by the government.

The U.S.-designed land-to-the-tiller program (Phase III), which split small, medium-sized farms among the peasants working on them, created more problems than it solved. Although the land was ceded to the peasants, transfer of actual title has been deferred during a 30-year period to enable them to "pay" for the land. The land is not transferable except by inheritance. Many peasants, therefore, have been burdened with owning land and a debt they do not wish to pay or cannot afford to pay. Many of the crops they grow, such as cotton, require periodic rotation to rest the soil and to avoid erosion. Stuck on these small plots and unable to rotate their crops as they did in the past by renting different plots every few years, peasants are left with decreasingly productive land. Their debts meanwhile grow.

Bank Nationalization

In 1981 the government nationalized the banks. This enables the government to allocate credit flows to public sector enterprises and removes many restraints on financing public sector growth. Between 1980 and 1985 the debt of the government to the Central Reserve Bank rose from $562 million to nearly $10 billion.

State Economic Controls

The state controls energy resources, including imported petroleum. The government energy monopoly buys oil at world market prices and resells it to local refineries at a profit of $7 to $8 a barrel. As world oil prices have fallen, moreover, the energy monopoly has not dropped its price. The result: Salvadoran individuals, factories, and businesses are paying more for energy despite collapsing oil prices worldwide.

To subsidize public transportation, the government has placed a 43 percent gasoline tax on distributors. Gasoline costs are thereby raised for commercial truckers who buy directly from the oil companies. This particularly hurts local private producers, who must now pay a higher cost to transport their goods at the same time the government keeps the prices on their goods down.

A number of industries are being absorbed into the public sector. Among them: cement construction, food distribution, textiles, and sugar. By controlling each stage of production--energy, construction, commodities, manufacturing, credit, and exports--the government ensures its monopolistic advantage over private enterprises, who must pay higher prices for these goods and services and who are obstructed by government bureaucratic red tape. Corruption is becoming a major problem, meanwhile, since the government trades political support for positions in the government that allow for personal gain. Observes an editor of a local newspaper: "In socialist countries where the government is increasingly involved in the economy, conflict of interest ceases to mean anything and corruption is legalized."[4]

DUARTE'S NEW AUSTERITY PLAN

In January, President Duarte unveiled a new economic program aimed at reducing the 40 percent inflation rate and at managing a rapidly expanding balance-of-payments deficit. The program devalued the currency, tightened credit, raised interest rates and taxes, and restricted imports to the private sector. These unwise and economically disastrous policies ironically reflect in large part the advice of IMF and U.S. Embassy officials. The new "austerity" measures halved buying power immediately and raised prices on most goods, thus hurting everybody from the labor sector to the small private businessmen. Not surprisingly, the anti-government guerrillas quickly exploited the economic programs' unpopularity, while labor unions led major strikes in protest.

In response, Duarte slapped price controls on rice, beans, cooking oil, public transportation--to "protect the poor." He also increased the minimum wage by about 50 percent and raised public employees' salaries.

Although an unclassified U.S. Embassy cable describes the new program as a "basis for solid economic growth in the future," its reliance on the usual IMF austerity prescriptions is nearly certain to cripple El Salvador's economy in the long run. The higher taxes, credit restrictions, foreign investment barriers, and new limits on imports impose disincentives that could strangle any society's productive potential. And while this raises the cost of production, the government holds prices down.[5] To make matters much worse, the state monopolies, particularly the agrarian reform program, will continue to have priority over the private sector in the demand for local credits and in their substantial allocations from the 1986 budget.

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4. Interview with Mario Rosenthal, editor, El Salvador News Gazette, El Salvador, May 6, 1986.

5. Noting the contradictions in Duarte's economic program, a local economist stated, "...in El Salvador the extraordinary thing is that inflationary measures, such as raising the price of petroleum products, increasing the minimum wage, and a general increase for all government employees were taken simultaneously with price controls and devaluation of the colon and credit and import restrictions, intended to check inflation." "Economic Crisis is Political Crisis," El Salvador News Gazette, February 17-23, 1986, p. 2.

In April, the Salvadoran legislature passed an export promotion law to "efficiently step up the nontraditional exports" to reactivate the economy. The new law supports the development of new export industries, eases filing requirements, and provides various tax exemptions for local exporters. Though a step in the right direction, these provisions may be undermined by the overall deterioration of the economy and a shrinking credit market. The government is promoting, and in effect subsidizing, the costly creation of new export industries that will take many years to mature. Instead of tinkering with gimmicks and new programs, the government should increase coffee production greatly in the next few years by creating the proper incentives, such as reducing taxes and allowing coffee growers to keep the major portion of their profits. The infrastructure exists as does the capacity to produce coffee at the high 1979 levels. The current high world price for coffee is expected to last for about two years. Along with lower priced oil imports, this would provide the country a favorable balance of trade.

PRIVATE PROPERTY

Private property rights are crucial for the investor confidence that triggers and sustains economic expansion. Yet such rights have not been secure since the expropriation of private property in 1980 and seem less assured now. So far the Duarte government has been ambiguous at best in policies affecting the private sector. A new law, for instance, empowers municipalities to confiscate urban property when a two-thirds majority of any city council votes that such action will benefit the community. Since Duarte's Christian Democratic Party controls most city councils, acts of confiscation would go largely unopposed. Such a measure naturally alarms the private investors who rightfully fear that, if their investments in local urban areas became profitable, they would become targets of city councils anxious to increase their wealth and power.

Investor confidence, so crucial for economic growth, is also adversely affected by the disarray of the civil courts system and the lack of legal guarantees for contracts and property. Government ambiguity toward the Phase II land reform has also deterred investment, particularly among coffee growers worried over area limitations under the program. A reformed nonpolitical judiciary is needed to ensure that civil rights are protected against political goals.

THE ROLE OF THE U.S.

El Salvador's economic deterioration and growing dependence on foreign aid signal loudly that something is wrong with U.S. aid policies to that country. The Duarte government, which has been allowed--probably even encouraged--by U.S. officials to pursue collectivist quasi-socialist policies, is carrying El Salvador to the brink of economic ruin. This could undermine its fragile democracy. U.S. officials at the State Department and at the U.S. Embassy in San Salvador continue to support economic policies that are doing much more to destroy the economy's productive sector and infrastructure than any sporadic bombing by leftist guerrillas.

Among the U.S. Embassy's most serious mistakes was its active promotion of the present austerity program and endorsement of Duarte's raising wages and fixing prices. These measures will force many small and medium-sized businesses into bankruptcy while the government is allowed to increase its spending and extend its control over the economy. If El Salvador's economic crisis is allowed to worsen, the anti-Duarte leftist guerrillas' work may be done for them, as the people's confidence in the democratic system erodes and other alternatives are sought.

POLICY RECOMMENDATIONS

Coffee Production

The U.S. should encourage El Salvador to provide free market incentives to coffee producers. A quick way to do this would be to reduce the onerous export taxes on producers. Reducing restrictions and taxes on coffee production would have a long-term benefit for the government and the country, since growers would be encouraged to invest in the future and expand production. And this of course would increase the state's income tax revenues.

The government should be encouraged to allow producers of coffee and other commodities to sell some portion of their goods on the free market. This would provide incentives to growers as well as undercut a growing illegal trade with Honduras and Guatemala.

Credit Policies and Exchange

Despite the clear directives from the Reagan Administration to foster the private sector in developing economies, the bulk of AID money for El Salvador still goes to the government's Central Bank and public sector projects. To ensure that private groups receive a larger share in field missions, the U.S. should require that private groups receive at least 40 percent of program aid. Example: a $100 million agricultural program should include at least $40 million for such private groups as small private producers, business organizations, and local farm credit organizations, some of which now receive AID money. There has been some recognition by AID officials that too much was being spent on El Salvador's land reform projects and that more money is needed for small private farmers. This insight, however, is ignored at AID headquarters, for the bulk of agricultural development money being requested by AID for fiscal 1987 is still to "strengthen agrarian reform."[6]

To streamline financial assistance to small private farmers and businesses, AID should route more of its funds through Private Voluntary Organizations (PVOs). Although AID states that PVOs are an "integral part of AID economic assistance to El Salvador," PVOs account for only 1.2 percent of the total assistance given. Moreover, their purpose is not to develop the private sector but to support agrarian reform projects, family planning objectives, and humanitarian assistance. These organizations include, for example, Technoserve Inc., which provides management assistance to agrarian reform cooperatives, the Salvadoran Demographics Association, which promotes family planning, and humanitarian organizations such as Project Hope and Save the Children. AID needs to expand its funding of PVOs to include local private producer and business organizations. Using PVOs would avoid the red tape of government bureaucracies and insulate aid from local politics.

Privatization of Land Reform

The U.S. should provide credits directly to peasants working on cooperatives to enable them to buy their plots. This would eliminate gradually the role of the centralized bureaucratic land reform agencies. Private voluntary organizations, such as Technoserve Inc., could contract with the U.S. government for this project and ensure that peasants are given not only the loans needed to buy and invest in their land but also the technical assistance to make these lands productive. Technoserve is now being employed by AID and the Salvadoran government to help the land reform cooperatives become self-managing enterprises, and its expertise could easily be oriented toward private sector development. Only this in the long run will lessen the need for U.S. aid.

Austerity Measures

U.S. support of International Monetary Fund-style austerity measures adopted by the Duarte government in January should be

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6. AID Congressional Presentation, Fiscal Year 1987, Annex III, Latin America and the Caribbean shows that, of a total $41 million in agricultural support programs, $32 million is targeted for land reform and $9 million for private small farmers. See pp. 92-97.

reconsidered. These policies violate completely Ronald Reagan's long-held and frequently stated policy of fostering growth in developing countries. U.S. aid should be granted only on condition that Duarte promote the free market through liberalizing export trade and welcoming foreign investment. U.S. aid also should promote privatization of such government enterprises as the land reform and coffee agencies. Washington should devise incentives, moreover, for Duarte to cut back public sector spending. Increasing productivity through freer markets and privatization will eliminate the need for subsidies, welfare programs, and a host of social programs currently being designed to respond to the country's economic deterioration.

Judicial Reform

The U.S. should provide technical and financial assistance to create an independent Salvadoran judiciary, which, among other things, will protect individual property owners from arbitrary confiscation. El Salvador needs a nonpolitical judiciary to ensure that legal rights supersede political goals.

U.S. support for judicial reform so far has concentrated on improving the methods of apprehending and prosecuting those accused of violating human rights. Now that human rights violations have decreased and progress has been made in criminal prosecution, more U.S. aid should be targeted to the protection of basic civil rights, which is vital to the daily lives of the Salvadoran people and should be a major goal of U.S. policy.

CONCLUSION

El Salvador is yet one more case of well-intended U.S. aid gone wrong. Instead of promoting an economically robust El Salvador, the U.S. has pushed policies that ensure Salvadoran economic failure and chronic dependency on foreign aid. For the nearly $1 billion that the U.S. has given El Salvador, little has been bought that will last. Yet it is not too late for the State Department and the U.S. Agency for International Development to initiate Reagan policies that would help this small country develop the economic environment needed to make it a prosperous and economically independent state. With concern over federal deficits forcing new restrictions on U.S. foreign aid programs, U.S. policy makers need to ensure that U.S. aid buys results for its bucks. It can do this only by igniting self-sustaining economic growth rather than dependency in recipient countries. Recipient countries should be made aware of the limits of U.S. aid and be encouraged to become independent of U.S. props.

In the case of the strategically important El Salvador, greater economic prosperity for all its people will foster a greater commitment to democracy. Regional security depends on the survival of

Central America's fledgling democracies, which must be sustained by sound, long-term economic growth. This was supposed to be Ronald Reagan's promise to developing nations. So far, however, his Administration has failed to fulfill it.

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