



# LIBERTY & PROSPERITY

## DEVELOPMENT POLICY ANALYSIS

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## El Salvador

### *A Central American Tiger?*

by **Juan Carlos Hidalgo**

### *Executive Summary*

**E**l Salvador is becoming an economic success story in Central America. Since the end of the civil conflict in 1992, which left the country in ruins, El Salvador has transformed its economy by implementing a far-reaching liberalization process undertaken by democratic governments, which has included the privatization of state enterprises, deregulation, trade and financial liberalization, privatization of the pension system, and the adoption of the U.S. dollar as its official currency. According to the Fraser Institute's *Economic Freedom of the World Report*, El Salvador ranks among the top 25 freest economies in the world.

The results of the market reforms are notable: between 1991 and 2007, the percentage of households below the poverty line fell from 60 percent to 34.6 percent. However, official figures point to mediocre average annual per capita growth during the period 1992–2007—only 1.9 percent—

which is very similar to Latin America's average of 1.6 percent in the same period. But official figures grossly underestimate the performance of the economy because of flawed measurement. In fact, the economy is probably more than 30 percent larger than indicated by the official data. Accordingly, the average per capita growth rate since 1992 has been approximately 5.2 percent per year.

El Salvador still has much to do on its policy agenda. In particular, high crime rates constitute a major hindrance to further growth. This lack of security represents the greatest threat to sustained growth and liberal policies.

Nonetheless, the country is showing the rest of the region how economic freedom can pave the way for development and how globalization offers great opportunities for developing countries that are willing to implement a coherent set of mutually supportive market reforms.

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Few imagined that El Salvador could become an example of successful economic development.

## Introduction

Only 17 years ago, few imagined that El Salvador could become an example of successful economic development. Back then, this small Central American country, comprising a mere 8,124 square miles—slightly smaller than Massachusetts—and with a population of around 5.7 million, was recovering from a bloody civil war that claimed more than 75,000 lives.

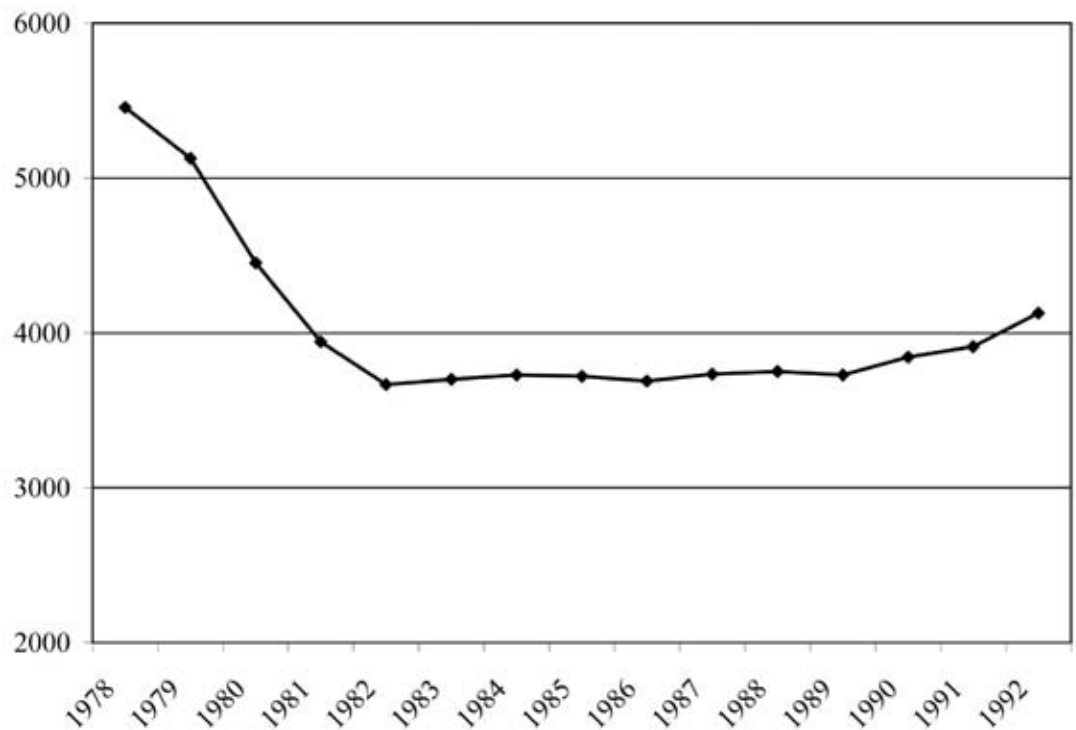
During the 1980s, El Salvador was a front in the Cold War, with the United States backing the government and the Soviet Union backing the country's Marxist guerrillas. Urban fighting in the heart of the capital San Salvador, murder of civilians by death squads, and kidnappings and disappearances became common during the decade. Poverty worsened during that period, growing from 50 percent of households in 1976 to 61 percent in 1988.<sup>1</sup>

During the years of conflict, economic policy in El Salvador was characterized by the omnipresence of the government, which used the civil war as a pretext to increase its control over nearly all sectors of the nation's economy. The process was marked by corruption and a stark decline in the main economic and social indicators. Thus, from 1978 to 1992 per capita income in El Salvador declined by 24.1 percent (see Figure 1).<sup>2</sup>

Twelve years of civil war finally came to an end in 1992 with the signing of a peace agreement between the government and the leftist rebels. At that time, El Salvador's economy was in a precarious state, with the country's infrastructure in ruins, the majority of the population mired in poverty, and hundreds of thousands of Salvadorans leaving for the United States to find work.<sup>3</sup> Jump-starting the Salvadoran economy made for a formidable challenge.

Nevertheless, Salvadoran government offi-

**Figure 1**  
Per capita GDP 1978–1992 (constant 2005 \$U.S., Purchasing Power Parity)



Source: World Bank, *World Development Indicators*, Washington.

cials undertook an aggressive program of economic liberalization that has transformed the country's economy and yielded major improvements in various socioeconomic areas. Some of these market reforms—such as the reprivatization of banks and the financial liberalization of 1990—predate the 1992 peace accord. Since the 1990s, this process has picked up pace with further privatizations of state enterprises, trade liberalization, pension reform, and the adoption of the dollar as the official currency.

The extent of El Salvador's market reforms is reflected in the country's rising ranking in the Fraser Institute's *Economic Freedom of the World Report*. In 1990, El Salvador was ranked 84th in the world, with a score of 4.81 out of a possible 10—yet by 2006, it ranked 25th out of 141 countries, with a score of 7.51. This qualified it as the third-freest economy in Latin America, after Chile and Costa Rica.<sup>4</sup>

These economic reforms have had a profound impact on the country's leading social indicators. According to the World Bank, between 1991 and 2002, "Net enrollment in primary education increased by close to 10 percentage points, infant mortality declined by 40 percent, population without access to safe water was halved and extreme poverty was reduced by half. By 2000, El Salvador was well positioned to meet most of the 2015 Millennium Development Goals ahead of schedule."<sup>5</sup> In 1991, the percentage of households below the poverty line was around 60 percent; by 2007, that figure had fallen to 34.6 percent. During the same period, the percentage of households living in extreme poverty fell from 28.2 percent to 10.8 percent.<sup>6</sup>

The improvement in average Salvadorans' quality of life is most evident in the array of consumer goods available to the population today compared to those available in 1992. For example, the number of households with electricity, refrigerators, and televisions increased by nearly 20 percent during this period; meanwhile the number of households using firewood for cooking decreased by 24 percent (see Figure 2).

The fight against poverty would have

made even greater strides had nature not dealt El Salvador some serious blows. In early 2001, two powerful earthquakes affected nearly 20 percent of the country's population, causing an estimated \$1.6 billion in damages—about 12 percent of the GDP.<sup>7</sup> And as if that were not enough, in 2005 El Salvador was battered again, this time by Hurricane Stan, which caused significant human and material losses.

The Salvadoran people's support for free-market reforms was evident in the country's presidential election in March 2004, in which the incumbent Alianza Republicana Nacionalista (ARENA) party<sup>8</sup> candidate, Antonio Saca, won resoundingly with 57 percent of the vote. Meanwhile, the candidate for the leftist Farabundo Martí para la Liberación Nacional (FMLN), Shafik Handal—who had campaigned on a promise to "dismantle the neoliberal model"—garnered a mere 35 percent.

While El Salvador still has a long way to go to be considered a developed nation, it has taken important steps in the fight against poverty—from which other countries with similar circumstances can draw important lessons.

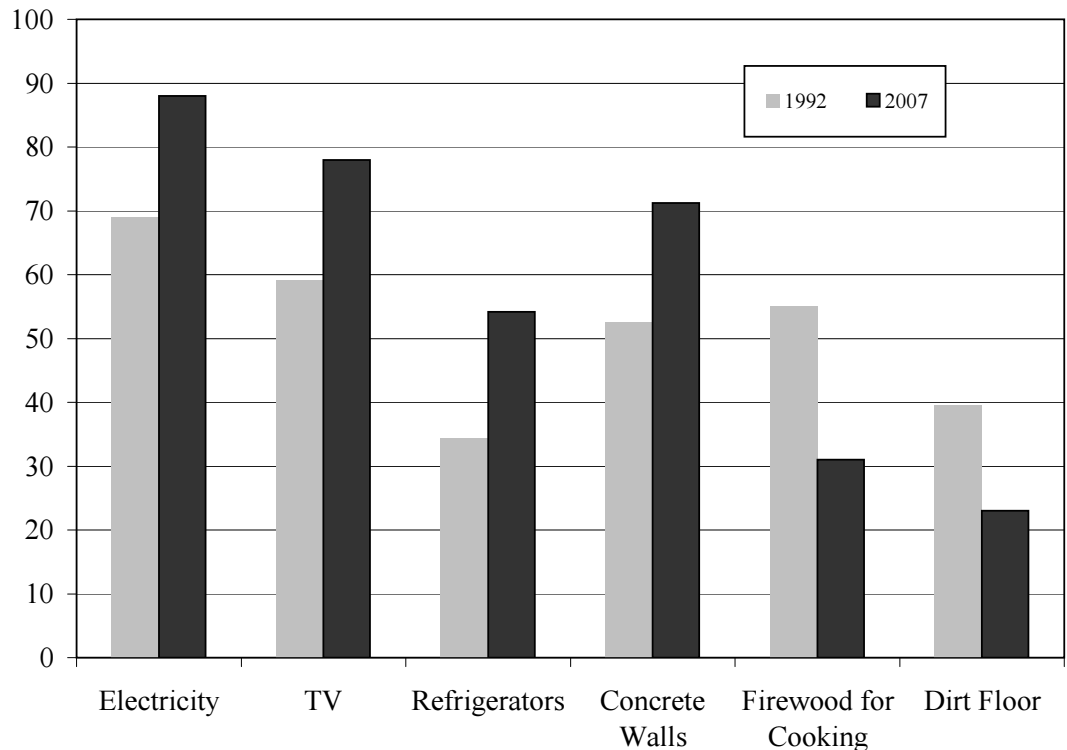
## The First Step: Financial Deregulation

The reprivatization of the banking sector, starting in 1990, launched the first round of economic reforms during the administration of President Alfredo Cristiani (1989–1994).

Salvadoran banks had been nationalized in March 1980, at the start of the civil conflict. While the authorities at the time justified this move as a way to alleviate income inequality and to expand access to credit, the real reasons were political and military. The nationalization of the banks resulted in a highly concentrated financial sector and a highly politicized process of access to credit. The results were disastrous: during 1979–1989, bank deposits shrank by 26.3 percent and private sector credit decreased by 43.6 percent.<sup>9</sup> The armed conflict surely also contributed to the country's

**The 1990 reprivatization of the banking system helped transform El Salvador's financial sector.**

**Figure 2**  
**Quality of Life Indicators 1992–2007 (percentage of households)**



Source: General Office of Statistics and Census, Population and Housing Census of 1992 and 2007, San Salvador.

economic contraction, but the deficiencies in assigning loans were great: the banking system's bad debt stood at \$434 million on December 31, 1989, which constituted 37.4 percent of all loans.<sup>10</sup>

The 1990 reprivatization of the banking system helped transform El Salvador's financial sector. As a preliminary measure, prior to transferring financial institutions to private ownership, the government undertook a process to fix the nation's private credit, either directly through infusions of capital or indirectly through the purchase of bad loans. For this purpose, a financial support and resolution fund was established (*Fondo de Saneamiento y Fortalecimiento Financiero*), and was capitalized by commercial bank shares and contributions from the government and the central bank. The government proceeded to either stabilize or liquidate those banks whose financial stability was severely compromised, depending on each institution's circumstances. Following the

reinforcement of credit and the privatization of banks, interest rates for both loans and savings were freely determined without interference from the country's monetary authorities, as was the case with private lines of credit extended with private capital.

The early 1990s also saw the enactment of a series of laws intended to establish a new regulatory framework for the entire financial sector, including legislation regarding currency exchange, stock trading, the creation of a new regulator (*Superintendencia del Sector Financiero*), and establishing new functions for the central bank (*Banco Central de Reserva*, or BCR). In this regard, the central bank was barred from financing the government or private enterprises, either directly or indirectly.

The financial sector has grown since then, with the emergence of a stock market in 1992, 15 brokerages, private pension fund management firms, and the free entry and exit of banking institutions. Currently, there

**The central bank was barred from financing the government or private enterprises, either directly or indirectly.**

are 10 banks and 5 nonbank brokers operating in El Salvador, as well as one foreign bank with local branches. Under the 1999 banking law and its subsequent amendments, foreign banks enjoy the same treatment as their local counterparts and can offer the same lines of products and services. This has introduced a level of financial competition that does not exist in most other Latin American countries. Moreover, during 2005–2006, the country’s four main banks—which are also among the largest in Central America—were acquired by major foreign financial institutions such as HSBC, Bancolombia, and Citibank. Today, El Salvador has the largest presence of foreign banks in Central America, surpassing even Panama.<sup>11</sup>

This liberalization process has increased competition and efficiency in the financial sector. In less than a decade, the nation’s interest margin—that is, the difference in interest rates between loans and savings—had been cut from 17.8 percent at the beginning of 1992 to 10 percent at the end of 2000.<sup>12</sup>

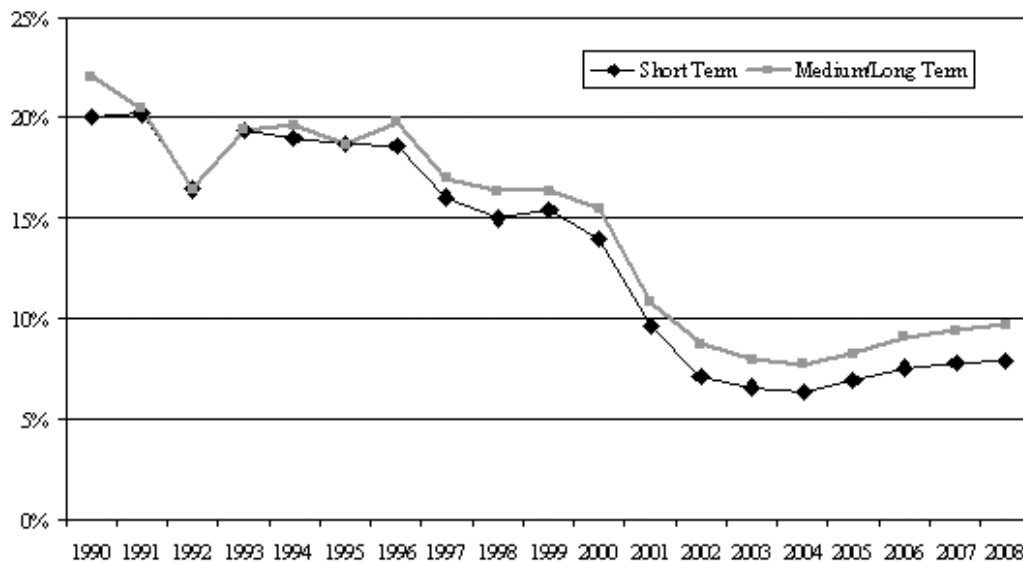
Private bank deposits recovered quickly. In

just four years (1994–1998) they increased by 70.2 percent, which demonstrates a great deal of public confidence in the financial liberalization. Similarly, commercial bank credit saw an increase of 11.7 percent during the same period. Over 80 percent of credit during that time was directed toward the private sector, with bad loans accounting for less than 5 percent of all credit—confirming the health of the system.<sup>13</sup> The Salvadoran financial sector’s net assets increased from \$1.88 billion in 1990 to \$6.88 billion a decade later—an increase of 266 percent, even though the number of banks increased by only two during the period.<sup>14</sup> While the peace accords played an important role in the banking sector’s recovery, by all accounts it has been El Salvador’s financial liberalization that has helped to energize the country’s economy.

Thanks to a more disciplined monetary policy, and the consequent fall in inflation—in addition to increased banking competition—interest rates on loans have gone down considerably, a change later secured by dollarization in 2001 (see Figure 3).

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**Figure 3**  
**Loan Interest Rates 1990–2008 (yearly average for short-term and medium- to long-term loans)**



Source: Central Reserve Bank of El Salvador, San Salvador.

**Salvadoran officials decided to emulate the private system adopted by Chile 17 years earlier.**

## **Pension Privatization**

El Salvador's financial liberalization was consolidated by the privatization of the nation's social security system, through the implementation of a private accounts system similar to that adopted in Chile in 1981. On April 14, 1998, a new pension system based on individual capitalization—part of the second round of economic reforms—replaced the old redistributionist public system. The public pension system was experiencing insolvency problems because of demographic changes and the economic instability engendered by the armed conflict. The strife of the 1980s resulted in an expansion of the informal sector and slashed the value of reserves as a result of high inflation.

Rather than experiment with schemes to extend the life of the public pension system—such as increasing either the retirement age or individual contributions—Salvadoran officials decided to emulate the private system adopted by Chile 17 years earlier. The new Salvadoran system is based on the following characteristics:

1. Individual capitalization. The system consists of individual accounts that are the property of each account holder, who contributes 13 percent of his/her salary to the account. These contributions and the profits they earn make up the savings of each individual worker over the course of his/her career.
2. Private management. Worker contributions are managed by competing private pension fund management firms, which are entrusted with investing those funds in the stock market under strict regulations. The program began operating with five management firms, but that number has been reduced to two today.
3. Freedom of choice. Workers may choose their pension fund administrator, as well as the terms of their own retirement.
4. Backup state subsidy. The government guarantees a minimum pension to

those persons who have worked the required time period yet have not managed to accumulate sufficient funds to cover their basic necessities in retirement.

The transition to the new system was accomplished as follows: All workers over 36 years old but younger than 55 (men) and 50 (women) were given the option of either staying with the old state pension system or transitioning to a personal private account. Those workers either entering the labor force for the first time or under 36 years old had their retirement funds transferred to a private account in a pension fund company of their choice. Individuals over 50 (women) and 55 (men) remained enrolled in the old state system. Those workers who were transferred to a pension fund company were given a “certificate of transition” that documented the amount of money that they contributed to the state system during their working lives. In order to pay the obligations under these certificates, the government established an amortization fund that was financed by a combination of state pension system reserves and contributions from the government's general budget. However, as the state pension reserves have become exhausted and expenditures have increased because of the growing number of retirees, the government has begun issuing investment certificates, which are used to pay the certificates of transition to the private pension fund companies.

The consolidation of domestic savings, combined with an open financial system, can help a small economy to better face the vagaries of global investment flows. The accumulation of these savings is a direct result of adopting policies that encourage individual capital accumulation. Thus, 10 years following the adoption of El Salvador's pension reforms, individual pension accounts represented 22.5 percent of the country's GDP.<sup>15</sup>

Nevertheless, El Salvador's private sector has yet to take full advantage of this accumulation of capital: as of March 2008, 79.1 percent of private pension fund companies'

investments were still in instruments issued by public institutions. In part, this is a result of the transition from the old public system to the new private one, since the government required the private pension fund companies to purchase bonds to help the government pay its own pension obligations. As the system matures, the amount of funds invested by the private pension funds in state instruments should diminish gradually.

However, other factors have been cited as contributing to this accumulation. Dani Rodrik and Ricardo Hausmann of Harvard University point to the lack of a high-risk financial sector.<sup>16</sup> A more plausible explanation may be the legal restrictions that prevent private account managers from investing heavily in domestic company shares offered in the stock market. Under current legislation, private pension fund companies may only acquire shares rated “A” by at least two credit rating agencies. This drastically reduces the size of the market, since the number of shares that meet this requirement is very small.

Another significant factor is the prohibition on private pension fund companies to invest part of their assets outside the country. This is in contrast to other Latin American countries such as Chile and Peru, which allow such investment. Ending this prohibition is essential to reducing the amount of funds invested in state financial instruments, which threatens those instruments’ long-term viability and runs counter to the fundamental principle of risk diversification. For example, the historical real return on pension funds is low, with an annual average of only 4.7 percent during 1999–2007.<sup>17</sup> By comparison, during the first nine years after Chile’s pension reform, the return on that country’s pension funds averaged 9.6 percent annually, and the historic return since 1981 has averaged 8.9 percent per year.<sup>18</sup>

Despite these limitations, the adoption of a private pension system has had significant consequences for El Salvador’s economy. First, it is fixing the solvency problems that existed under the old system. Second, it fundamentally

changed the management of pension funds by substituting a system that encouraged consumption with one that encourages saving and investment. Moreover, the private system increased workers’ freedom to choose how, with whom, and how much to invest; when to access their money; and when to retire. This may be the most important feature of a private system, since it gives workers control over their own futures—much to the detriment of the political class, which, under the old system, would make retirement decisions for the country’s entire workforce. As of March 2008, the number of persons who have signed up for the private contribution system was 1,658,349—which represents 87 percent of the country’s active labor market population.<sup>19</sup>

Finally, El Salvador’s pension reform complemented the implementation of other policy changes, such as trade liberalization. As José Piñera, former labor minister in Chile and architect of that country’s pension reform, notes, “the investment of pension funds in the market makes every worker a capitalist, one who participates in an overt manner in an economy that competes internationally. . . . Free trade is good for the economy, and what is good for the economy is good for investors.”<sup>20</sup> Thus, El Salvador’s social security privatization would serve as the foundation for other reforms, including trade liberalization.

## **Integrating into the Global Economy: Trade Liberalization**

At the same time as it liberalized its financial sector, and as part of the third generation of reforms, El Salvador began a process of trade liberalization that consisted of the reduction and elimination of tariff barriers and the implementation of bilateral trade agreements with other nations.

El Salvador went from having an average trade tariff of 23 percent in 1987<sup>21</sup> to a trade duty of around 4 percent in 2004—the lowest in Central America and one of the lowest in all

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**Exports have grown by a robust rate of 11.2 percent annually since 1991—the highest long-term export growth rate in Latin America.**

of Latin America. Moreover, in 1995, duties on capital goods and raw materials were eliminated altogether.<sup>22</sup> El Salvador has also been one of the drivers of the process of harmonizing tariff rules in Central America, which has generally led to a reduction of trade barriers throughout the isthmus. By standardizing trade rules, the nations of Central America have taken a significant step toward the creation of a common market for a total population of 30 million people, which would make the region more attractive for foreign direct investment. In addition, the common market puts Central America on the road to negotiate trade agreements with other nations and trade blocs that want to negotiate with the region as a whole. One such bloc is the European Union, which began to negotiate an association agreement with Central American countries in the second half of 2007.

In addition to the Central American Common Market, which has been in effect since 1960 as a regional free-trade zone, in recent years El Salvador has signed bilateral agreements with Mexico, the Dominican Republic, Panama, Colombia, and Taiwan. It is currently negotiating an FTA with the 15 members of the Caribbean Community (Caricom). Negotiations for a trade deal between Canada, and El Salvador, Honduras, Guatemala, and Nicaragua were suspended in 2004 at an advanced stage, but are expected to resume in the future.<sup>23</sup>

At a multilateral level, El Salvador became a member of the General Agreement on Tariffs and Trade in 1990 and of its successor, the World Trade Organization, since the body's founding in 1995. Thus, El Salvador has committed itself to observing the principles governing world trade under WTO rules, as well as related rules that are relevant to market access, investment, services, and more.

The biggest prize for El Salvador in terms of trade policy is the free-trade agreement with its largest trading partner, the United States. By 2007, 50.8 percent of El Salvador's exports went to the United States, while 35.6 percent of imports originated from there.<sup>24</sup> In 2002, Salvadoran president Francisco Flores (1999–2004),

at the time president pro tempore of the Central American Integration System, proposed to U.S. president George W. Bush to launch negotiations for a free-trade agreement between the United States and the five Central American republics—Guatemala, Honduras, El Salvador, Nicaragua, and Costa Rica. The Dominican Republic was later added to the agreement, which was then named DR-CAFTA.

On December 17, 2004, El Salvador became the first country to ratify DR-CAFTA, which went into effect on March 1, 2006. Under the agreement, El Salvador consolidated and expanded the trade benefits it enjoyed under the Caribbean Basin Initiative, a unilateral U.S. concession regime that allows countries in the Caribbean and Central America to export a wide range of products duty-free. Even more importantly, El Salvador has opened up its market further to American products, which helps bring down the cost of living for millions of Salvadorans.

Since the end of El Salvador's civil war, the country's import and export sectors have experienced a change that is more qualitative than quantitative. While exports have grown by a robust rate of 11.2 percent annually since 1991—the highest long-term export growth rate in Latin America—the mix of export goods has changed significantly, with a significant relative decrease in the country's traditional exports—such as coffee, sugar, and shrimp—and a greater share of non-traditional export products—such as manufactured goods, vegetables, and various types of seafood. In 1991, traditional products accounted for 37.4 percent of El Salvador's total exports; by 2007 their share of the country's exports had plummeted to 6.5 percent. This trend underscores the transition to a more competitive economy based on the production of more value-added products. Imports have also increased at a similar pace (11.5 percent annually during 1991–2007), which shows increased consumption by Salvadorans, thanks to both lower import tariffs and greater purchasing power.

Trade liberalization yields additional benefits beyond those that can be quantified in macroeconomic figures. It reduces the power



of the government—and by extension, the power of politicians—to decide which economic sectors are to be protected through tariff barriers and regulations. It also diminishes the potential for corruption and favoritism, since it takes away opportunities for rent-seeking on the part of businessmen looking for state protection. Trade liberalization thus fosters a healthier relationship between government and businesses, one that has tended to be incestuous in traditionally highly protected business environments.

Altogether, international trade as a percentage of El Salvador's GDP has risen from 42.1 percent in 1991 to 62.1 percent in 2007, which represents a significant integration of the country into the global economy.<sup>25</sup> It is worth noting that this export surge occurred despite the adoption of the dollar as the country's official currency in 2001. In contrast to other countries in the region where a mercantilist mentality still predominates, El Salvador did not attempt to promote its exports through devaluation or any other form of currency manipulation. Such manipulation negatively affects workers' incomes and assets by reducing the purchasing power of their salaries and pensions.

Regulatory and legal certainty is another important benefit of trade agreements, and is an important cause of increased trade and investment following the finalization of trade deals.<sup>26</sup> The increase in foreign direct investment in El Salvador provides evidence: the annual average of foreign direct investment received by El Salvador in the three years following the ratification of DR-CAFTA is 37.8 percent higher than the annual average in the three years prior to the treaty's ratification.

## **A Dollarization Not Prompted by Crisis**

El Salvador's greater participation in the global economy paved the way for another important reform approved in 2000, this time in the realm of monetary policy. In November of that year, Salvadoran lawmakers passed the

Monetary Integration Law, which substituted the Salvadoran *colón* with the U.S. dollar (at a fixed exchange rate of 8.75 *colones* per dollar). In addition, the law allowed people to enter into contractual agreements in any foreign currency in legal circulation.

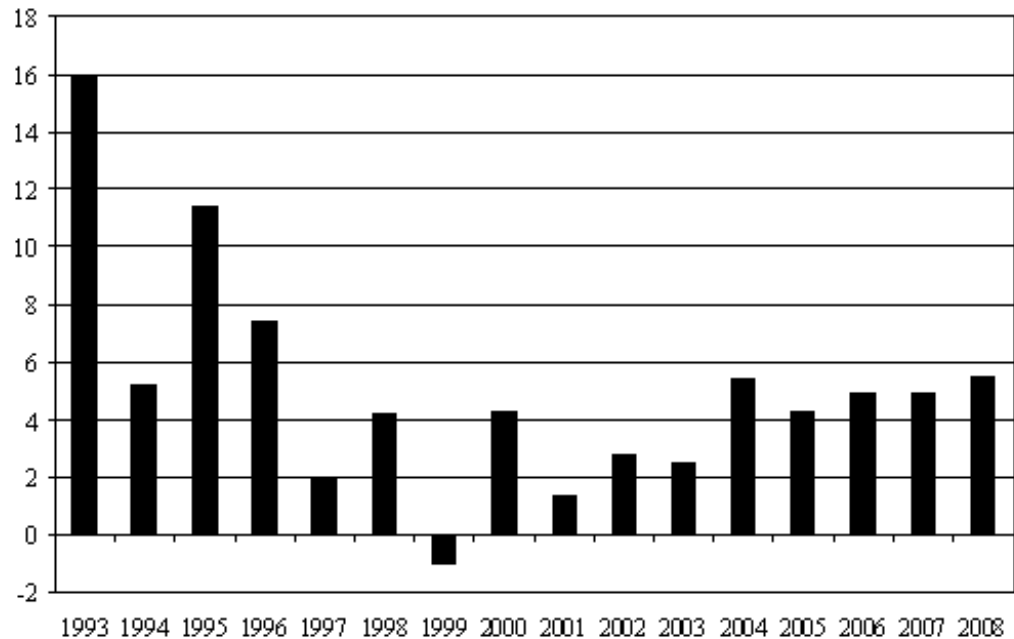
In contrast to other similar processes, El Salvador's dollarization was not carried out in the midst of a crippling inflationary crisis, as was the case in Ecuador.<sup>27</sup> To the contrary, the average annual inflation rate during 1996–2000 was only 3.36 percent. Rather, the substitution of the *colón* for the dollar was intended to promote growth. Salvadoran officials were well aware of the role played by expectations in generating the conditions necessary for economic development—especially in the context of Latin America, where inconsistency in the observance and enforcement of government policies tends to be the norm. Thus, dollarization sought to accomplish four basic objectives:

1. Eliminate the risk of devaluation to protect the cash value of deposits, pensions, and salaries.
2. Lower interest rates and increase competition in the financial sector.
3. Encourage private investment.
4. Minimize the lack of monetary credibility, which is common for emerging economies, through the elimination of independent monetary policy.

The average annual inflation rate has stayed around 3.9 percent during 2001–2008, even though in recent years it has experienced an unusual increase for a dollarized economy (see Figure 4). Ironically, dollarization may be responsible for the higher-than-usual inflation, since the massive influx of family remittances—comprising 18.1 percent of GDP in 2007—has increased the amount of money in circulation in the country, and thus helped push up prices of consumer goods. Even if the inflationary effect of remittances can be mitigated by using those remittances to finance imports, they still represent an increase in the money supply that must be taken into account when analyzing

**El Salvador became the first country to ratify DR-CAFTA.**

**Figure 4**  
**Average Annual Rate of Inflation 1993–2008**



Source: General Office of Statistics and Census, San Salvador.

inflation rates in El Salvador. The circumstances of El Salvador's economy may be unique in the world: small, dollarized, and with an enormous inflow of remittances. Even so, the Salvadoran economy has been the sixth-least inflationary in Latin America during 2003–2007, which speaks very well of the recent efforts of other Latin American countries to control inflation.

Regarding the direct effects upon the economy, banks' annual average loan interest rate dropped from 10.8 percent in 2001 to 7.7 percent in 2004, but then rose slightly to 9.4 percent in 2007. Taking into account the private sector financial liabilities during 2001–2007, the drop in interest rates following dollarization represented savings of \$2.5 billion in interest payments during the period—money that was made available for Salvadoran businesses and families to cover other expenses.<sup>28</sup>

Dollarization has also helped to restore government fiscal discipline, which had been

undermined in the early years of the decade, in part because of the government's challenges in responding to the natural disasters that battered the country at that time. By the mid-1990s, credit rating agencies gave El Salvador one of the highest rankings in Latin America after Mexico and Chile. Thanks to dollarization, the public sector non-financial deficit has been cut from 4.4 percent of GDP in 2002 to an estimated 0.3 percent in 2007.

From a practical perspective, it is important to note that the dollarization transition process was helped along by the infusion of billions of dollars each year through remittances from Salvadoran nationals in the United States to their family members back in El Salvador. In 2007, remittances reached \$3.7 billion. However, this does not take away from the fact that dollarization led to the desired results, and that the country's residents today enjoy stability in their cost of living thanks to the government's decision to give up control over monetary policy.

**In contrast to other countries in the region El Salvador did not attempt to promote its exports through devaluation.**

## Liberalization and Privatization of Public Services

To truly appreciate the progress that El Salvador has made in privatizing and opening its markets in telecommunications, energy, and hydrocarbons, it is important to recognize that national infrastructure in these areas had yet to recover from years of insufficient investment because of the armed conflict. That situation made the participation of the private sector imperative in order to overcome this gap.

In 1997, El Salvador's new telecommunications law was approved. It opened the telecom sector to competition and established a regulatory framework for telephony and use of the electromagnetic spectrum. This statute, one of the most liberal in the world, instituted free competition in telecoms so that "prices and terms of service in telecommunications between operators shall be negotiated freely."<sup>29</sup> In addition, the law bars suppliers from segmenting the market among themselves, and also bars cross-subsidies of telecom companies that are in competition with one another. Finally, the statute introduced strong property rights protections over the electromagnetic spectrum, stipulating that every concession for use of the spectrum is a "private good, being transferable and open to fragmentation."<sup>30</sup>

Salvadoran officials then went further that same year, when they privatized the National Telecommunications Administration, ANTEL,

the state telephone company. One of the reasons given for this measure was the unsatisfied demand and poor coverage for telecom services in El Salvador in the years of state monopoly, when telephone service density was only 8.68 lines per 100 inhabitants. Today, El Salvador's telecommunications market enjoys vibrant competition among 10 land-line telephone service providers and 4 mobile phone firms, which offer their services directly to consumers. Competition has allowed the sector to experience sustained growth, which is reflected in the number of persons with access to either a land or mobile telephone line. As Table 1 shows, there are currently more telephones than people in El Salvador. By the end of 2007, the country had 124 telephone lines—including both land and mobile—per 100 inhabitants. The number of mobile phone lines has increased by more than 30,000 percent since 1997.

Market opening was not limited to telecoms. It was also extended to other sectors of the economy, including energy and hydrocarbons. For example, in 1996 El Salvador liberalized and opened up the electricity market. The electricity reform also disaggregated the state energy company into various companies dedicated to generation, transmission, and distribution, some of which were sold to foreign investors. Private investment in electricity has allowed the rapid development of geothermal energy, which has enormous potential in El Salvador because of the country's location in an area of high volcanic activity. In recent years, geothermal energy has

**Dollarization has also helped to restore government fiscal discipline.**

**Table 1**  
**Development of Telecommunications in El Salvador, 1997–2007**

	1997	2007	% of variation
Number of land lines	360,830	1,080,083	199.3%
Land line density*	6.41	18.62	190.4%
Number of mobile lines	20,122	6,137,381	30,400.8%
Mobile phone density*	2.27	105.82	4,561.7%
General phone density*	8.68	124.44	1,333.0%

\* Number of users per 100 persons.

Source: Superintendent's Office of Telecommunications of El Salvador.

**There are currently more telephones than people in El Salvador.**

**Table 2**  
**Prices of Gasoline and Diesel to End Consumers in Central America, November 14, 2008**  
**(\$U.S. per gallon)**

Country	Gasoline		Diesel
	Premium	Regular	
Guatemala	3.48	3.35	3.35
Honduras	3.20	3.00	3.12
Nicaragua	3.35	3.23	3.29
Costa Rica	4.65	4.50	4.12
El Salvador	2.95	2.72	3.03

Source: Ministry of Economy of El Salvador.

come to comprise over a fourth of the country's total electrical generation.

With hydrocarbons, El Salvador went from a completely regulated market in 1992 to one in which the government limits itself to monitoring consumer prices on a weekly basis, with the aim of informing consumers about the best prices available at the country's filling stations. The government does not import or refine fuels, and it does not regulate consumer prices in any way. Growing competition in recent years has allowed the emergence of independent service stations—thanks to the simplification in the licensing process for station operators—which has helped reduce the cost margins accumulated throughout the oil-supply chain. According to a 2005 study by the UN Economic Commission for Latin America, in the three years prior to the study those margins had come down in El Salvador from 40 U.S. cents to 34 U.S. cents per gallon, while other countries in the region that had highly regulated markets, such as Costa Rica and Honduras, had seen those margins rise.<sup>31</sup> Thus, it should not be surprising that by November 2008, El Salvador had the lowest fuel prices in Central America (see Table 2).

By opening such strategic sectors as telecommunications, energy, and hydrocarbons to competition and private investment, El Salvador helped to ensure the provision of modern, efficient, and competitive services in areas on which the entire economy depends. In contrast with Mexico, where state and private monop-

lies predominate, El Salvador does not suffer from supply bottlenecks in the provision of these goods. Moreover, the government made the right decision in transferring the responsibility to build, upgrade, and maintain infrastructure in these areas to the private sector—doing otherwise would have imposed a significant burden on state finances. Salvadoran officials wisely applied the maxim that if the private sector can provide a good or service and can do so better than the government, then there is no reason for the state to become involved in providing that same good or service. Moreover, unlike privatizations carried out in other Latin American countries such as Argentina and Mexico, El Salvador's privatization process generally has been characterized by its transparency. Reforms in El Salvador have not given rise to either private monopolies or captive markets, and no corruption scandals implicating anyone involved in the process have come to light. This transparency is one of the most important features that lend legitimacy to the Salvadoran market reforms that were begun in the 1990s.

### **Fiscal Policy: Responsibility without Creativity**

Despite an onslaught of natural disasters, including two earthquakes in 2001 and Hurricane Stan in 2005, El Salvador's government has managed to maintain the fiscal

discipline that has characterized its performance since the late 1980s. The national government reduced its fiscal deficit from 3.1 percent of GDP in 2002 to 0.5 percent of GDP in 2007, allowing El Salvador to enjoy, after Chile and Mexico, one of the best sovereign risk grades in Latin America by Moody's and Standard and Poor's rating agencies. Deficit reduction has been made possible by a small decline in government spending—which went from 15.6 percent of GDP in 2002 to 15.4 percent of GDP in 2007—and an increase in tax revenues, from 12.5 percent of GDP in 2002 to 14.9 percent in 2007 (see Figure 5).

However, the low tax burden—that is, tax revenues as a percentage of GDP—should not be interpreted as indicating that El Salvador is a fiscal paradise with uniquely attractive tax rates. On the contrary, El Salvador's tax rates are similar to those of other countries in the region. For example, the top corporate and individual income tax rates both stand at 25 percent—both close to the Latin American average. The value-added tax stands at 13 percent and, as in the rest of Latin America, is

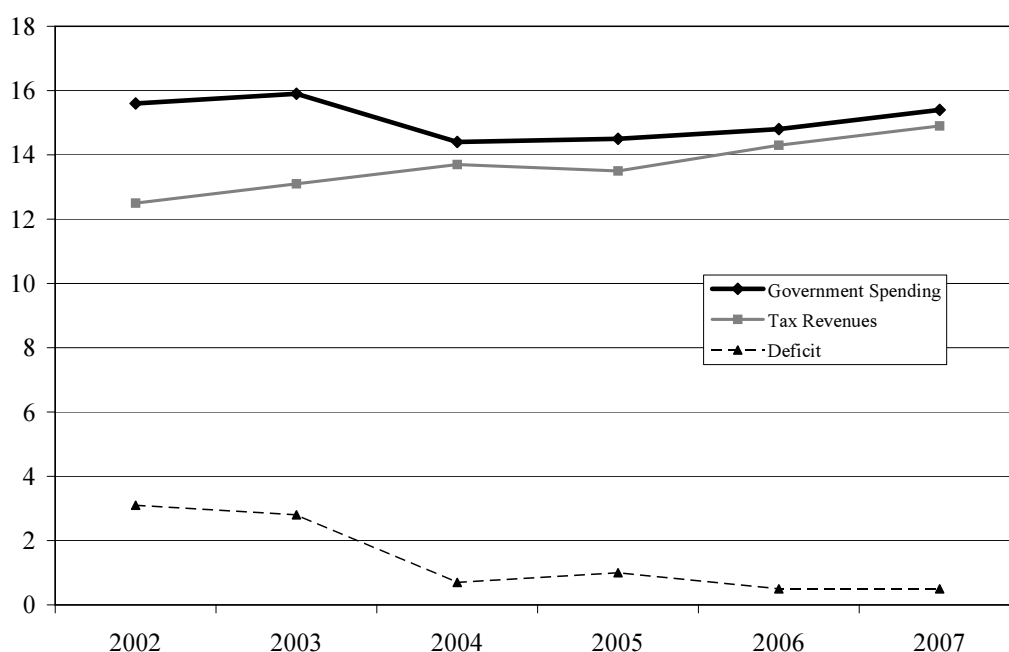
the main source of government tax revenue, accounting for 53.8 percent of overall revenue in 2007.<sup>32</sup> Nevertheless, compared to other countries in the region, El Salvador has few taxes. In addition to income taxes and the VAT, the country has only two direct consumption taxes (on alcohol and tobacco), import taxes (among the lowest in Latin America), and a 3 percent duty on real estate transactions above \$250,000.

There is still room for improvement in El Salvador's tax policy. A World Bank report, *Paying Taxes*, not only ranks the tax rates among 178 countries, but rates the ease of paying taxes—that is, the amount of transactions that a business must carry out to pay taxes, as well as the number of hours dedicated to paying taxes. In this area, El Salvador performs poorly—ranking 101st in the world. The country gets poor grades in the number of payments (66) and in the number of hours required to pay taxes (224).<sup>33</sup>

Unfortunately, Salvadoran fiscal policy has not been subject to innovative measures to enhance the country's competitiveness. El Salvador could increase its attractiveness to

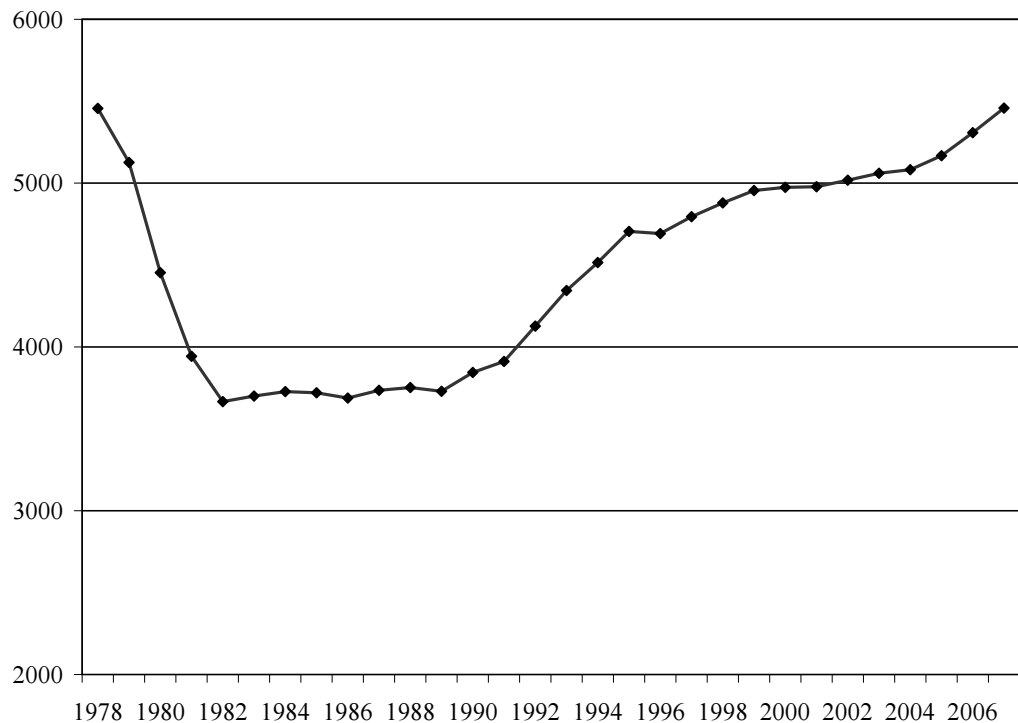
**Reforms in El Salvador have not given rise to either private monopolies or captive markets.**

**Figure 5**  
Tax Revenues, Government Spending, and Deficit as a Share of GDP, 2002–2007



Source: Central Reserve Bank of El Salvador, San Salvador.

**Figure 6**  
**Official per Capita GDP, 1978–2007 (constant 2005 \$U.S., Purchasing Power Parity)**



Source: World Bank, *World Development Indicators*, Washington.

investors—both local and foreign—as well as improve its fiscal situation by adopting a low flat tax, which would reduce current corporate tax rates and minimize the tax system’s complexity—and thus reduce incentives for tax avoidance and tax evasion. To this end, El Salvador could learn from the experiences of Eastern European countries that have adopted flat-tax systems over the past decade.<sup>34</sup> A fiscal policy based on simple and low taxes would be the perfect complement to the reforms already realized in other areas of the Salvadoran economy.

### **Development without Growth?**

Economic theory and practice both suggest that implementing the public policies indicated above will generate growth rates that in the medium- to long-term will foster economic

development and reduce poverty. Without high growth rates, there can be no rapid development.<sup>35</sup> However, El Salvador seems to be a case of development without significant growth. Since the end of the civil war in 1992, per capita GDP has grown by an unimpressive 1.9 percent annually. Apart from a brief period during the 1990s (1992–1995) when it grew by an average of 4.5 percent per year, El Salvador’s per capita GDP has not grown significantly despite the country’s economic reforms. It was not until 2007 that the country’s per capita GDP achieved the purchasing power parity income level it had in 1978, the year before the start of the civil war (see Figure 6). This situation has vexed economists. Harvard University’s Dani Rodrik describes the situation as “puzzling,” and notes, “El Salvador looks like a country with very good institutions for its low level of income.”<sup>36</sup>

How can a country reduce the percentage of households below the poverty line by near-

**Transparency is one of the most important features that lend legitimacy to the Salvadoran market reforms that were begun in the 1990s.**

ly half with such a meager per capita growth rate? Could it be that El Salvador has not in fact developed and that the marked improvements in the country's social indicators are the result of the hundreds of millions of dollars that Salvadorans receive in remittances year after year as suggested by some non-governmental organizations?<sup>37</sup>

One reason for this disparity between indicators lies in the poor quality of the data on which they are based. For example, the country's most recent census results, published in May 2008, revealed that El Salvador had 1.4 million fewer people than originally projected. This change in population figures alone substantially alters the country's per capita GDP numbers, among other figures. An estimate based on the new census figures shows that by 2007, per capita GDP would be 17 percent higher than the official figure (see Figure 7).

Therefore, according to the revised population data, El Salvador's per capita GDP has grown by 3.3 percent since 1992—the third-highest rate in Latin America during this period, after the Dominican Republic (3.8

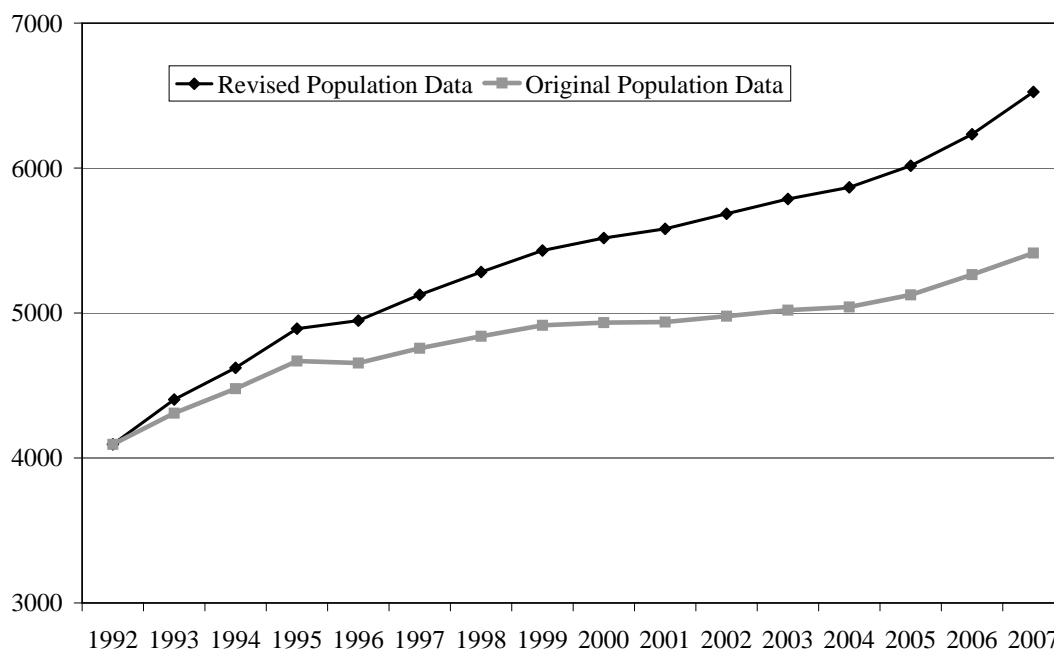
percent) and Chile (3.6 percent).<sup>38</sup> Even so, such a rate is not characteristic of a “tiger” economy, especially one that has experienced both deep economic reforms and marked social improvements.

El Salvador's low-growth figures may be a result of the way the country collects economic data. According to Manuel Hinds, former Salvadoran finance minister and architect of the country's dollarization process, there is good reason to believe that the country's data underestimates the economic growth rate. Hinds notes that throughout El Salvador there are many visible signs, such as more highways, telephone lines, and shopping centers, which suggest that the country has grown at a faster rate than the official figures indicate. For example, between 2000 and 2005, manufacturing in El Salvador grew more rapidly than in any other country in Latin America. A growth rate below 2 percent is incongruous for a national economy exhibiting such dynamism.

Hinds contends that the problem lies in the services sector being undervalued in the

**El Salvador's annual per capita growth rate between 1992 and 2007 stands at approximately 5.2 percent.**

**Figure 7**  
**Per capita GDP, 1992–2007 (constant 2005 \$U.S., Purchasing Power Parity)**



Sources: World Bank, *World Development Indicators*, Washington; and Manuel Hinds, May 2008.

**Other countries  
in the region  
that also  
underwent peace  
processes and  
democratization  
have not seen  
poverty level  
reductions similar  
to that in El  
Salvador.**

country's estimation of GDP:

How can an error in national economic data come about? Very easy. Such data are derived from a sample of products that are considered representative of each sector. This sample is designed from a detailed economic census that provides two kinds of information. The first is a detailed estimate of production during the year surveyed. The second is a sample of products that comprise the majority of each sector, so that in subsequent years such production may be estimated by measuring only these dominant products. If these grow, the entire sector is considered to grow, and vice versa. The problem is that if the economy is changing in its fundamental makeup—new economic activities emerge as others recede—this method will tend to underestimate actual production. The loss of production in the declining sectors will be included in the estimate, while the gains in the new emerging sectors will not. The base survey currently used in El Salvador was developed in 1992, in an economy totally different from that of today. Underestimates are very likely when a long time has passed and the economy has changed so much.<sup>39</sup>

This anomaly is especially evident in the services sector: as demand for services increases because of increases in consumption and investment, the supply of services should be expected to grow in nearly proportional fashion. However, Hinds finds that the country's economic data indicate not only that the supply of services is not growing at a pace consistent with the demand for them, but that the capacity of supply to meet demand during 1995–2005 was the lowest during the last 40 years—including during the civil war.<sup>40</sup> In addition to Hinds' analysis, the marked development of sectors like telecommunications over the past decade—thanks to liberalization and privatization—makes the official growth

figures even harder to take seriously. For example, during 1998–2007, investment in services averaged 67.7 percent of annual foreign direct investment in El Salvador.<sup>41</sup>

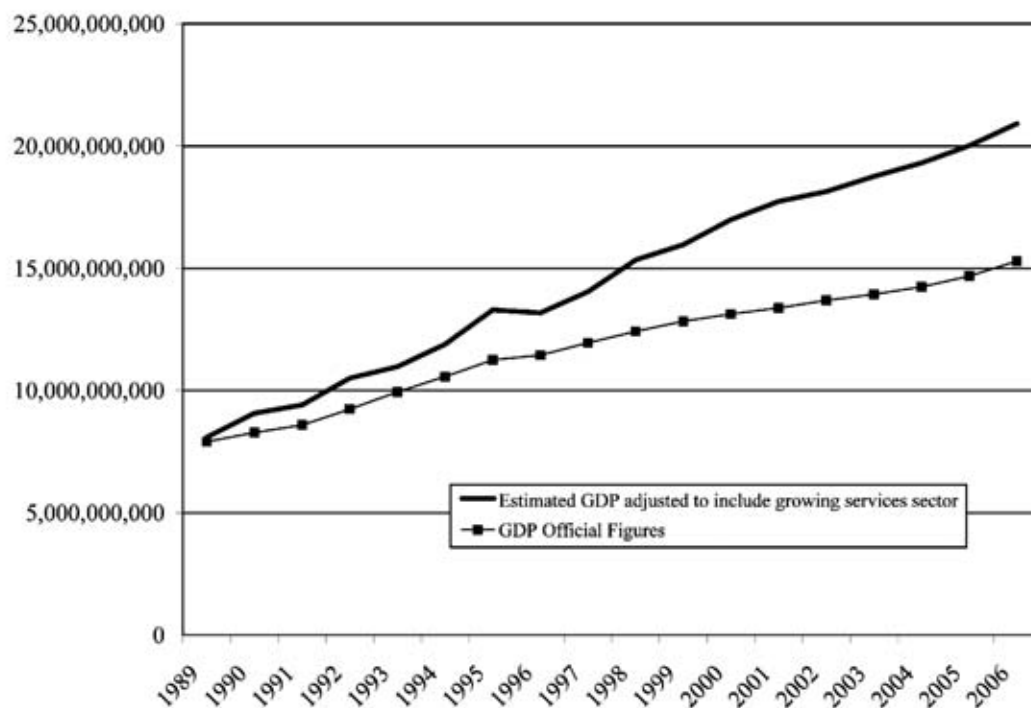
But if the official figures are in error, as seems likely, is there a way to estimate El Salvador's true growth rate? Hinds attempts this by calculating the supply of services during 1989–2006 with the same response capacity that those in-demand services had during 1960–1988. Substituting official figures with these revised numbers, Hinds concludes that El Salvador's GDP in 2006 was 36.7 percent higher than official figures indicate (see Figure 8). In addition, he estimates the average annual growth rate during 1989–2006 at 5.7 percent, rather than the official figure of 2.1 percent. It is worth noting that Hinds starts from the assumption that the supply of services during 1989–2006 showed the same average capacity to respond to demand as during 1960–1988. However, as already noted, it is safe to assume that the services sector experienced even greater growth because of increased competition and private investment since the 1990s.

Hinds' thesis appears to be borne out by a long-term growth estimate in the World Bank's 2003 *Country Economic Memorandum* for El Salvador, which indicates that given the conditions during the period of 1996–1999, the country's expected annual growth rate during that time should have been 6.2 percent.<sup>42</sup> Moreover, an International Monetary Fund delegation that visited the country in 2005 recommended to the local authorities that they revise the formula for calculating GDP. According to press reports, the IMF "believes that the scheme for calculating GDP is not congruent with the new economy based on services, an area in which it considers El Salvador the leader in the region. Yet calculations are still made according to an agriculture-based model."<sup>43</sup>

Taking into account Hinds' estimates and the revised population data, El Salvador's annual per capita growth rate between 1992 and 2007 stands at approximately 5.2 percent, a markedly higher figure than the official estimate of 1.9 percent per year.



**Figure 8**  
**El Salvador GDP 1989–2006, Estimated and Official Figures (constant 2000 \$U.S.)**



Source: Manuel Hinds, “¿Cuánto estamos creciendo? Compensando la Inconsistencia,” *El Diario de Hoy* (El Salvador), June 10, 2005. (Updated by Hinds in May 2008.)

Despite uncertainty over El Salvador’s true growth rate over the past decade, the case for it being notably higher than official figures indicate is compelling and is supported by international observers. El Salvador’s significant advances in poverty reduction and in human development indicators are hardly characteristic of the laggard economy suggested by the official figures.

### Other Possible Causes of El Salvador’s Development

While there may be room for debate regarding the Salvadoran economy’s true growth rate, there is little room for disagreement regarding the substantial improvements in citizens’ quality of life, as social indicators show. There remains some uncertainty, however, over whether these social improvements are due more to the economic reforms or to other

phenomena, such as the end of the civil conflict or family remittances from Salvadorans living outside the country.

*Peace:* Without a doubt, securing peace has contributed to economic growth, as would be the case in any country that experienced more than a decade of civil war. The fact that the Salvadoran economy’s healthy growth rates during the brief period following the end of the war (4.5 percent per year during 1992–1995) later slowed down appears to suggest that the return of peace does in fact help explain the economy’s improved performance. However, other countries in the region that also underwent peace processes and democratization, such as Nicaragua and Guatemala, have not seen poverty level reductions similar to that in El Salvador.<sup>44</sup> Further, the quality and prices for services in El Salvador following privatization are in great measure more attractive than in other countries, such as Costa Rica, which has enjoyed peace and stability for

**If remittances are playing an increasingly important role in reducing poverty in El Salvador, it is because an increasingly dynamic economy allows it.**

**Security under the rule of law is an essential component of a liberal policy agenda.**

over 60 years, but which until recently adhered to a mixed economy model characterized by inefficient state monopolies in telecommunications, insurance, hydrocarbons, and other industries.

El Salvador would never have been able to launch its economic liberalization process had it remained engulfed in a crippling civil war. Therefore, the role that peace has played in the country's economic transformation should not be neglected, but it alone does not explain the socioeconomic achievements of the last decade and a half.

*Family remittances:* In 2007, El Salvador received \$3.7 billion in remittances, which was around 18.1 percent of the country's GDP. No doubt that such a large inflow of money would greatly impact the country's economy and the quality of life of its residents. But are remittances the reason for El Salvador's marked improvement in its social indicators in the last 17 years? If that were the case, other countries in the region that have also received large cash inflows through remittances—such as Haiti (29 percent of GDP), Nicaragua (18 percent), and Jamaica (17 percent)<sup>45</sup>—would have enjoyed similar reductions in poverty levels. Yet such is not the case, and the reasons are obvious: an influx of money will help promote growth and reduce poverty if the country enjoys a favorable economic climate. Thus, remittances may well have contributed to El Salvador's economic development, but that is because the market reforms of recent years created the conditions for growth.

What effect do remittances have on poverty reduction? According to a study by the UN Economic Commission for Latin America, remittances to El Salvador helped reduce poverty by 4.5 percent. That is a notable figure, but not enough to explain the reduction by nearly 25 percentage points in the number of households below the poverty line that was achieved between 1991 and 2007. The study also notes that “the repercussions of remittances upon poverty among the entire population are of little significance.”<sup>46</sup> In 2006, a World Bank report analyzed the impact of remittances among 11 Latin American coun-

tries, and found that in El Salvador they helped reduce poverty by 5.1 percentage points.<sup>47</sup>

The role of remittances in improving the recipients' quality of life should not be underestimated, especially in satisfying short-term necessities for households that, in most cases, face significant economic limitations. However, if remittances are playing an increasingly important role in reducing poverty in El Salvador, it is because an increasingly dynamic economy allows it.

## **The Threat of Violence**

Despite El Salvador's favorable outlook resulting from its commitment to economic liberalization and integration into the world economy, there is another challenge that must be met if that country is to aspire to a good standard of living: citizens' security. Ironically, the main catalyst for the climate of violence that currently besets the country is a problem that has been imported from the United States—juvenile gangs, known as *maras*.<sup>48</sup>

Today, El Salvador is the most violent country in the world. In 2007, there were 3,491 murders, and the country had a murder rate of 60.7 per 100,000 inhabitants.<sup>49</sup> Gang violence is the main culprit behind these alarming figures. According to official figures, there are 10,000 gang members in El Salvador, and gangs are responsible for around 60 percent of all murders.

This lack of basic security imposes enormous costs on the Salvadoran economy and scares away investment. According to a study by El Salvador's National Public Security Council, the violence cost the country \$2 billion in 2006—nearly 11 percent of GDP.<sup>50</sup> That is a tremendous loss for a country trying to take off both economically and in terms of social indicators.

The failure of the ARENA administrations to address the lack of security in the country has helped to erode support for the party. Security under the rule of law is an essential component of a liberal policy agenda. Declining support for the ruling party is

understandable since security is a key ingredient of an individual's well-being and a basic notion of justice.

By imposing a significant burden on the economy and by creating popular discontent, high levels of violence represent the greatest threat to sustained growth and liberal policies in El Salvador. Unfortunately, there are no silver bullets to deal with the violence, especially when youth gangs—with their complex sociological background—have played such a prominent role as one of the main culprits.

## Conclusion

The serious problem that civil violence represents in no way diminishes the important strides that El Salvador has made over the last decade and a half. In Latin America, which even today finds itself locked in a struggle between fragile democracies and a centuries-old authoritarian populist tradition, this country presents a serious challenge to those who question whether economic liberty can set firm roots in the region.

The road ahead probably will not be easy. While El Salvador has indeed made a successful transition to peace and democracy, with the Marxist FMLN abandoning armed struggle in favor of electoral politics and becoming the country's main opposition party, it remains to be seen whether it has truly left behind its Marxist-Leninist ideology and close ties with Venezuelan president Hugo Chávez in favor of a modern center-left course along the lines of Chile's Concertación Nacional. The death of Shafik Handal in 2006, the FMLN's iconic leader, opened the door to such a transformation—on which depends the future of Salvadoran democracy. However, the FMLN's orthodox Marxist rhetoric has survived intact as the country heads into a presidential election this March,<sup>51</sup> which the FMLN has a serious chance of winning.<sup>52</sup>

Much remains to be done, especially at the micro level. One of the biggest failings of the reforms implemented during the 1990s throughout Latin America was to neglect the

implementation of measures that could have allowed the majority of the populace to enjoy the benefits of an open economy. If, for a majority of the people, increased access to property is not realized, and access to the market economy is blocked through a web of regulations and restrictions, discontent will grow and will sooner or later be manifested at the ballot box. If globalization has helped exacerbate social inequality in Latin America, it has been largely because the states allow only a select group to participate in that process while the door remains closed to a much larger number. To increase opportunities for the poor, it is necessary to promote property titling among the most disadvantaged sectors of society and to eliminate regulations and restrictions that prevent the establishment of formal enterprises.<sup>53</sup>

On that point, El Salvador still has a long way to go. According to the World Bank's *Doing Business 2009* report, starting a business in that country requires eight bureaucratic transactions that take a total of approximately 17 days to complete. The cost of starting a business in El Salvador thus represents 49.6 percent of per capita income. By contrast, in Canada, starting a business requires only 1 procedure that takes 5 days, at a cost of 0.5 percent of per capita income. In El Salvador, fulfilling all permit and licensing requirements for a new building requires 34 transactions, takes 155 days, and costs 176 percent of per capita income. In New Zealand, a similar undertaking would require 7 transactions that take 65 days to complete, and costs 25.8 percent of per capita income.<sup>54</sup> El Salvador has made significant strides in some of the areas measured in this World Bank index,<sup>55</sup> but with such significant bureaucratic obstacles, it is not surprising that 40 percent of the economically active population works in the informal sector.<sup>56</sup> For El Salvador's reforms to reach a greater potential, it is imperative for Salvadoran officials to reduce the costs of doing business.

There are many challenges ahead, and it will be a long time before El Salvador will join the ranks of developed countries. Yet El

**It is necessary to eliminate regulations and restrictions that prevent the establishment of formal enterprises.**

Salvador is showing the world that, despite difficult conditions and a tumultuous past, the road to development and a better standard of living is opened by economic liberty and the opportunities created by globalization.

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  34. For more on the merits of a flat tax and the experience of countries that have adopted it, see “Flat Tax Club,” in Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008), pp. 57–78.
  35. In fact, the term “tiger” gained currency in economics literature in reference to East Asian countries that experienced high growth rates, such as Hong Kong, Singapore, Taiwan, and South Korea. More recently, it has been used in reference to other high-growth countries, such as Ireland, whose rapidly growing economy has gained it the moniker of “Celtic tiger.”
  36. Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions and Economic Growth* (Princeton: Princeton University Press, 2007), p. 75. Rodrik blames El Salvador’s lackluster growth rate on the absence of opportunities for lucrative investments.
  37. For example, Jesus Aguilar of the Centro de Recursos Centroamericanos, a Washington-based nonprofit organization, has stated that “Remittances constitute the most important support of our economy since they are the main source of foreign currency our country has.” Jesus Aguilar, “El impacto social de las migraciones en El Salvador y desafíos,” CARECEN Internacional, January 2006, <http://www.freewebs.com/carecen/elsalvador/recursos.htm>.
  38. Manuel Hinds, “¿Que no crecía El Salvador?” *El Diario de Hoy* (El Salvador), May 15, 2008.
  39. Manuel Hinds, “¿Cuánto estamos creciendo? Los Censos,” *El Diario de Hoy* (El Salvador), June 3, 2005.
  40. To make this calculation, Hinds uses the coefficient of response by the services sector to demand, defined as the rate of growth of services divided by the rate of growth of demand for the same.
  41. Comisión Económica para América Latina y el Caribe, *Foreign Direct Investment in Latin America and the Caribbean* (2007), p. 90, <http://www.eclac>.

org/publicaciones/xml/1/32931/lcg2360i.pdf.

42. World Bank, “Republic of El Salvador: Country Economic Memorandum,” report no. 26238, December 16, 2003, p. 27.

43. “FMI pide nuevas reformas,” *El Diario de Hoy* (El Salvador), July 8, 2005.

44. According to Guatemala’s National Institute for Statistics, Guatemala’s poverty rate stood at 62 percent in 1989 and was reduced to 51 percent by 2006. In Nicaragua, the poverty rate went from 50.3 percent in 1994 to 46.2 percent in 2005, according to the country’s National Institute for Statistics and Census.

45. CEPAL, *Panorama Social de América Latina 2005* (Santiago: CEPAL, 2005), p. 97.

46. *Ibid.*, p. 103.

47. Pablo Acosta, Cesar Calderón, Pablo Fajnzylber, and Humberto López, “What is the Impact of International Remittances on Poverty and Inequality in Latin America?” World Bank, 2006, p. 33, [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/06/08/000016406\\_20070608122322/Rendered/PDF/wps4249.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/06/08/000016406_20070608122322/Rendered/PDF/wps4249.pdf).

48. These violent gangs arose at the end of the 1980s on the streets of Los Angeles and were “exported” to El Salvador and other Central American countries during the 1990s through deportations carried out by the U.S. government. For more on this topic, see Ana Arana, “How the Street Gangs Took Central America,” *Foreign Affairs* (May/June 2005): 98–109. While it is true that poverty plays a very important role in the proliferation of youth gangs, I do not believe that it is the only cause. After all, Nicaragua suffers from higher poverty levels than El Salvador—in addition to also having gone through a civil war in recent years—and yet has not fallen victim to this criminal scourge.

49. Suchit Chávez, “Censo revela tasas reales de homicidios en el país,” *La Prensa Gráfica* (El Salvador), May 14, 2008.

50. Carlos Acevedo, “Los costos económicos de la violencia en Centroamérica,” Consejo Nacional de Seguridad Pública de El Salvador, 2008, p. 14, [http://www.ocavi.com/docs\\_files/file\\_538.pdf](http://www.ocavi.com/docs_files/file_538.pdf).

51. While the Farabundo Martí para la Liberación Nacional’s presidential candidate, Mauricio Funes, is seen by many as a moderate, some high party figures—such as Medardo Gonzalez, the party’s general coordinator—have made clear their intentions

to undo the market reforms of recent years, including reversing dollarization and revisiting the free-trade agreement with the United States.

52. There are various reasons why the ruling party’s popularity has weakened. First, any party in power for 20 years is bound to create political fatigue that sooner or later will be reflected at the polls. Second, the reformist impulse that characterized the administrations of Alfredo Cristiani, Armando Calderón Sol, and Francisco Flores was lost during the government of Antonio Saca. This has reduced the level of socioeconomic improvements that could have been accomplished during the last five years. And yet, the ruling party candidate, Rodrigo Ávila, has adopted populist rhetoric that runs counter to the reforms accomplished over the last decade and a half. Third, there is an important demographic element: approximately 34 percent of El Salvador’s adult population is under 30 years old. Thus, there is a significant segment of voters who do not remember, or have very distant memories of, their country as it was 15 years ago. It is no coincidence that support for the FMLN is particularly strong among the younger population. As one of my Salvadoran colleagues noted during a visit to San Salvador in 2008, “It’s true; young people today have problems paying for their cell phones, gas for their cars, and college tuition. What they don’t remember is that 15 years ago their parents couldn’t afford phones or cars, lived in shanty towns, and couldn’t even dream of going to college.” Still, the failure to address the lack of security is perhaps the main reason behind the declining support for ARENA.

53. See Hernando de Soto, *The Other Path: The Economic Answer to Terrorism* (New York: Basic Books, 2003) and *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).

54. World Bank, *Doing Business 2009: Five Years of Reform* (Washington: World Bank, 2008).

55. For example, in 2008, El Salvador jumped 32 places in the ease of doing business, 13 places in cross-border trade, and 10 places in the costs of closing a business. However, during the same period, it backslid in other areas, such as ease of paying taxes (five places) and protection for investors and property registry (three places).

56. El Salvador Ministry of Economy, “Reporte Sistema de Información Seguimiento Económico—Análisis Comparativo-Emplo” (2005), [http://www.elsalvadorcompite.gob.sv/documentosIC/Reporte\\_SISE/2005/No6\\_Emplo.pdf](http://www.elsalvadorcompite.gob.sv/documentosIC/Reporte_SISE/2005/No6_Emplo.pdf).

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