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EL SALVADOR

FISCAL STRENGTHENING FOR INCLUSIVE GROWTH

(ES-L1093)

LOAN PROPOSAL

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ABBREVIATIONS

AFP	Administradora de Fondo de Pensión [pension fund administrator]
API	Fondo Apuesta por Inversiones [Investment Promotion Fund]
BCR	Central Reserve Bank
BOLPROS	Bolsa de Productos y Servicios de El Salvador [Salvadoran Goods and Services Exchange]
CIAT	Inter-American Center of Tax Administrations
CIP	Certificados de Inversión Previsional [pension investment certificates]
CNR	Centro Nacional de Registros [National Registry Center]
COMPRASAL	Sistema Electrónico de Compras Públicas de El Salvador [Salvadoran electronic procurement system]
DCTA	Tax and Customs Arrears Collection Division
DEM	Development Effectiveness Matrix
DGA	Customs Administration
DGICP	Investment and Public Credit Administration
DGII	Internal Revenue Administration
DGT	Treasury Administration
FGR	Office of the Attorney General
FOP	Fideicomiso de Obligaciones Previsionales [Pension Trust Fund]
IMF	International Monetary Fund
INSAFOCOOP	Instituto Salvadoreño de Fomento Cooperativo [Salvadoran Institute for the Promotion of Cooperatives]
ISSS	Salvadoran Social Security Administration
LACAP	Government Procurement Act
LRF	Fiscal Accountability Act for the Sustainability of Public Finances and Social Development
MLTFF	Medium- and long-term fiscal framework
MTEF	Medium-term expenditure framework
MTIF	Medium-term institutional framework
NFPS	Nonfinancial public sector
OECD	Organization for Economic Cooperation and Development
OMR	Organismo de Mejora Regulatoria [Regulatory Improvement Agency]
OVE	Office of Evaluation and Oversight
PBP	Programmatic policy-based loan
RBB	Results-based budgeting
RNPN	Registro Nacional de las Personas Naturales [National Citizen Registry]
SAFI-II	Sistema de Administración Financiera Integrado [integrated financial management system]
SAP	Sistema de Ahorro para Pensiones [pension savings system]
SIRH	Sistema Integral de Recursos Humanos [comprehensive human resource management system]
SPP	Sistema Público de Pensiones [public pension system]
SSF	Office of the Superintendent of the Financial System
STP	Technical Secretariat of the Office of the President
UNAC	Unidad Normativa de Adquisiciones y Contrataciones de la Administración Pública [Government Procurement and Contracting Regulatory Unit]
USAID	United States Agency for International Development

PROJECT SUMMARY

EL SALVADOR
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Financial Terms and Conditions				
Borrower: Republic of El Salvador			**Flexible Financing Facility**[a]	
			Amortization period:	20 years
			Disbursement period:	1 year
Executing agency: Ministry of Finance			**Grace period:**	5.5 years[b]
			Interest rate:	LIBOR-based
Source	**Amount (US$)**	**%**	**Credit fee:**	[c]
IDB (Ordinary Capital)	350,000,000	100	**Inspection and supervision fee:**	[c]
			Weighted average life (WAL):	12.75 years
Total	350,000,000	100	**Currency of approval:**	U.S. dollar

Project at a Glance
Project objective/description: The objective of this programmatic series and of this first operation is to strengthen fiscal sustainability, protecting public investment and social program funding to favor inclusive growth. The specific objectives are to: (i) boost the efficiency of fiscal management (with particular emphasis on the efficiency of public expenditure); and (ii) improve pension sustainability. This is the first of two Programmatic Policy-based Loans (PBPs), which will be contractually independent but technically related.
Special contractual condition precedent to the sole loan disbursement: Compliance with the policy reform conditions as established in the Policy Matrix (Annex II), the Policy Letter, and the remaining conditions established in the loan contract (paragraph 3.4) will be a special contractual condition precedent to the sole loan disbursement for the first operation in the series.
Exceptions to Bank policies: None

Strategic Alignment			
Challenges:[d]	SI ☑	PI ☑	EI ☐
Crosscutting themes:[e]	GD ☐	CC ☐	IC ☑

[a] Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

[b] Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

[c] The credit fee and the inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. PROJECT DESCRIPTION AND RESULTS MONITORING

A. Background, problems addressed, and rationale

1.1 **Macroeconomic situation.**[1] El Salvador has a small, dollarized (since 2001), and open economy which is vulnerable to external shocks and natural disasters. The economy grew at an average rate of 2% a year from 2000 to 2008. It shrank by 3.1% in 2009 and from then to 2017, it grew at rates between 1.4%-2.4% (Central Reserve Bank (BCR), 2018). Growth potential is relatively low (2%),[2] just one half of the Central American average. In the medium term, real GDP growth is expected to be between 2% and 2.5%.[3]

1.2 The current account deficit averaged 4.4% of GDP in the last decade, driven by the trade deficit (averaging 18.4% of GDP) and a heavy flow of payments abroad, albeit moderated by the flow of remittances (averaging 16.8% of GDP) and other net transfers abroad (2.8% of GDP). In 2017, the current account deficit fell to 1% of GDP from 2% in 2016, thanks to the improved conditions in the United States, which led to a higher flow of remittances, although they may be jeopardized by the cancellation of temporary protected status (TPS)[4] program and fluctuations in the U.S. economy.

1.3 Net international reserves, which averaged US$2.725 billion over the last decade, also grew in 2017 to US$3.273 billion (BCR, 2018), covering 4.4 months of imports in the medium term, 12 times the projected current account balance, and 126% of the short-term foreign debt plus service on long-term foreign debt.

1.4 The Salvadoran economy is characterized by low inflation. The figure was 2% in 2017, for an increase of 2.9 percentage points over 2016 (-0.9%). The changes in inflation are largely explained by fluctuations in oil prices.

1.5 **Fiscal situation.** The overall fiscal deficit averaged 3.2% of GDP from 2000 to 2008, rising to 5.7% in 2009 due to a drop in revenue (0.8 percentage points of GDP) and an increase in expenditure (1.6 percentage points).[5] Revenue recovered to its 2008 level, but spending continued to grow. The deficit averaged 4% until 2013 when various reforms were introduced. The government passed tax reforms to raise income tax rates and the rates and bases of selective taxes, and established new taxes.[6] As a result, the tax ratio rose from 14.3% in 2010 to 15.8%

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[1] The figures presented in this document and all of its annexes are estimated on the basis of the national accounts, whose baseline year is 1990, for consistency with the figures provided in the national budgets passed through the end of 2017 and with diagnostic studies conducted by the IDB and other donor organizations. The fiscal data will be updated with the national accounts using a new baseline in September 2019, multiplying by the corresponding factor, and therefore the second PBP and the results matrix will be adjusted to the new baseline as of that date. The changes do not affect the deficit and debt paths.

[2] International Monetary Fund (IMF), 2016a.

[3] The IMF projected growth of 2.1% in 2018 and of about 2% afterwards. The BCR projected growth of 2.5% in 2018 and similar levels in the following years.

[4] The United States cancelled TPS for more than 195,000 Salvadoran workers in January 2018.

[5] Hereinafter, unless otherwise stated, the deficit and expenditures both include pension spending.

[6] The income tax rate for the highest bracket was increased from 25% to 30%, and the minimum exemption was also raised (Legislative Decree (DL) 957-2011). A financial operations tax (DL-764-2014), a large taxpayer contribution (DL-161-2015), and a special contribution for security (DL-162-2015) were also created.

of GDP[7] in 2016, which was not sufficient to cover the rise in public expenditure (Ministry of Finance, 2018).

1.6 Public expenditure is rigid, has been contracyclical only in the recessionary cycle,[8] and rose from 20.1% of GDP in 2007 to 24.1% in 2013, mainly driven by the increase in nonfinancial public sector (NFPS) wages (1.7 percentage points of GDP), goods and services (0.8 percentage points of GDP), and subsidies (0.7 percentage points of GDP) (Ministry of Finance, 2018). Since then, and accompanying the tax policy measures, the government lowered its spending to 22.8% of GDP in 2016. This drop is partly explained by targeted energy subsidies[9] and lower oil prices, which generated savings of 1.2 percentage points of GDP in 2016 (Ministry of Finance, 2018). Capital expenditure was reduced from 3.2% to 3.0% of GDP in the same time frame.

1.7 The Sistema de Ahorro para las Pensiones [pension savings system] (SAP) introduced in 1998 replaced the Sistema Público de Pensiones [public pension system] (SPP) and contributed to the increase in expenditure since 2001 and, hence, to the fiscal deficit and the public debt. Miscalculation of the technical reserves needed to finance the transition period for workers belonging to the SPP forced the government to include the missing reserves in the annual budget.[10] A Fideicomiso de Obligaciones Previsionales (Pension Trust Fund) (FOP)[11] was set up in 2006 to cover these obligations and to issue Certificados de Inversión Previsional (pension investment certificates) (CIP).

1.8 **Public debt sustainability.** The NFPS debt grew over the period 2007-2016 by 21.6 percentage points of GDP, rising from 39.3% to 60.9%. Fourteen percentage points of this increase corresponded to pension liabilities (IMF, 2016a). The fiscal imbalance did not improve sufficiently after the tax reforms, and growth remained weak. Had the trend persisted, the deficit would have continued to rise, and the debt would have reached about 80% of GDP in 2023, jeopardizing its sustainability (IMF, 2016b). Actions to reduce the fiscal deficit by 3 percentage points of GDP were needed to reverse the trend (IMF, 2016b).

1.9 In 2016, based on dialogue and consensus-building among the country's different sectors, the authorities were able to reach important political agreements.[12] As a result, the government passed the Fiscal Accountability Act for the Sustainability of Public Finances and Social Development (LRF) at the end of 2016 and made changes to the SAP at the end of 2017. The Bank supported the process of reforming the regulatory frameworks of the LRF and the SAP from the idea stage, and subsequently provided technical advisory services for the Ministry of Finance

[7] Total tax revenue rose from 18.6% to 19.9% of GDP.

[8] This is typical of Latin American countries. It worsened with the 2008 crisis and partly explains the lower spending on infrastructure during the crisis. Consequently, fiscal rules that limit current expenditure but not capital spending can be efficient in these contexts (Izquierdo, Pessino, and Vuletin, 2018, in progress).

[9] Executive decrees 35-2011, 197-2014, and 6-2017.

[10] The reserves were exhausted four years after the reform was implemented (Mesa-Lago, 2012).

[11] The FOP Act (DL-98-2006) permitted the government to contract debt with Pension Fund Administrators (AFPs) at lower-than-market rates, cushioning the fiscal costs of pension commitments.

[12] In November 2016, the country's main political stakeholders signed a Framework Agreement for Fiscal Sustainability, Economic Development, and Stronger Government Liquidity in El Salvador.

during the reform, during its drafting, and during the regulatory and implementation process, which is ongoing. The implementation of these reforms is fundamental for stabilizing the public debt for at least the next three years. These reforms of the LRF and SAP coincided with the preparation of this program with the Bank and have been included in it. Through the provision of technical inputs,[13] the Bank also helped to build consensus that facilitated passage of the budget in 2018 as an integral part of the process of preparing this operation.[14] The reforms of the LRF and SAP, promoted under this program, reduce the tax ratio in the medium term and help generate a positive cumulative primary fiscal balance of 1.4 percentage points of GDP during 2017-2018 (FMI, 2018a). These measures, coupled with the other fiscal policy actions included in this program, are needed to stabilize the public debt, while protecting investment and equity, laying the groundwork for the subsequent implementation of longer term reforms.

1.10 **Problems addressed and their causes.** If fiscal sustainability is to be improved and inclusive economic growth promoted, it will be necessary to limit growth in spending and improve efficiency in the management of public expenditure (paragraph 1.40), giving priority to efficient public investment (paragraph 1.46) and protecting the budgets of key programs targeting the most vulnerable populations. The main problems are discussed below.

1.11 **Macrofiscal management.** Before the political agreements were reached in 2016, there were no legislated fiscal policy and management tools to promote public spending sustainability and efficiency. Specifically, there were no fiscal rules to control the fiscal deficit, debt growth, and current expenditure growth.[15] Given the debt growth trend observed up to 2016, it was desirable for the LRF to establish a three-year period of fiscal consolidation during which debt stabilization measures would be implemented.[16] Furthermore, the government had no medium- and long-term fiscal framework (MLTFF) that set clear guidelines for managing public finances during the consolidation period and took account of the fiscal obligations generated by the pension system and projected a multiyear baseline for fiscal policy decisions.

1.12 Given the low level of total investment in El Salvador (paragraph 1.17), growth in current expenditure needed to be curbed to protect public investment.[17] The increase in current spending related to increases in the public sector payroll[18] and

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13 Technical analysis of the 2018 draft budget (IDB, 2017).

14 Passage of the 2018 budget was delayed until January 2018 because it was necessary to observe the Constitutional Court's decision of 27 July 2017, which ordered measures to guarantee a balanced budget. It was also necessary to comply with the LRF, which made it difficult to reach agreements in the Legislative Assembly for the budget's passage.

15 Fiscal rules in Central America have sought to bring about sustainability, reduce the procyclicality of fiscal policy (Klem, 2014), and optimize the size of government (IMF, 2009).

16 The Bank's current program has made it possible to stabilize the public debt.

17 Fiscal rules containing deficit targets, accompanied by caps on growth in spending, can lead to better performance than purely structural rules, favoring medium-term public savings and financial sustainability (IMF, 2013).

18 Spending on wages in 2016 was 9.2% of GDP, and rose from 7.1% in 2008 to 8.7% of GDP in 2013 owing to the increase in the number of employees (24.1%) and the increase in average wages (12.1%) (IDB, 2016). The payroll grew due to higher employment in the health, education, and citizen security sectors (Dumas and Lafuente, 2016). In recent years, this has been mainly due to wage increases in the health and education sectors.

procurement of goods and services acts as a constraint on the capacity to achieve primary surpluses, and therefore mitigation measures are required, while protecting the budgets of programs targeting vulnerable and poor populations. In relation to the wage bill, decentralized human resource management places upward pressure on current expenditure. The existing comprehensive human resources management system (SIRH)[19] does not produce reliable, well-organized, or relevant information on operations management or electronic payroll processes that can be used to develop internal controls on public wages and can lead to potential leakage or fraud in human resource management systems.

1.13 **Government procurement management.** Government procurement processes are not efficient or transparent because of shortcomings in the legal framework, the institutional architecture, operating capacity, transparency,[20] and the delay in implementing a portal for electronic transactions[21] that would lead to savings in public expenditure.[22]

1.14 The main problems identified are: (i) the processes provided for in the Government Procurement Act (LACAP) are still performed manually, raising transaction costs and affecting the transparency of procurement. The government's official procurement portal, the Salvadoran electronic procurement system (COMPRASAL-II), is mainly used to publish announcements, bid calls, and contracts, but not for transactions; (ii) the "open tenders" procurement method[23] (14% of the total) continues to be operated manually, under which bidders submit their bids to the institution that issued the call (IDB, 2016d) (in some cases, invitations are issued, without open public tenders, which affects the traceability, auditing, and transparency of the process, however a start is being made on implementing the electronic open tenders module); (iii) the 2000 LACAP is out of date in various aspects that would improve the system, including the following: (a) it created just one procurement unit, the Government Procurement and Contracting Regulatory Unit (UNAC), which reports to the Ministry of Finance but has little capacity to manage and control all government procurement; (b) it failed

[19] The SIRH currently includes about 160,000 employees in 94 central government institutions. The coverage is not complete, and therefore the system may include ghost employees (IMF, 2016c).

[20] In an evaluation of public procurement (Organization for Cooperation and Economic Development (OECD)/Development Assistance Committee (DAC) methodology), El Salvador scored an average of 1.2 out of a maximum of 4 in 2010, distributed among these four pillars. Limited progress has been made since then, particularly in completing the first COMPRASAL module (the annual procurement and contracting plan) and starting up the open tenders module (IDB, 2010a; USAID, 2017).

[21] In 2004, a start was made on reporting procurement on the Internet using COMPRASAL. By 2010, when the amounts reported in COMPRASAL awards were compared to those reported in the integrated financial management system (SAFI), the conclusion was that a significant number of procurements are conducted outside the system (IDB, 2010, a and b). Based on this first comprehensive diagnostic assessment, the IDB designed a strategic plan and an action plan for 2010-2015 which spells out the guidelines for today's COMPRASAL-II, including the following modules: the annual procurement and contracting plan, open tenders, bids, competitions and direct contracting, and contract management (IDB, 2010c).

[22] Failure to tap the potential for scale through consolidated procurement and the absence of reference prices leads to inflated budgets and many different prices paid for the same good or service in different government institutions.

[23] Open tenders is a simplified contracting process whereby government institutions procure and contract works, goods, services, and consulting services up to the legal threshold. The thresholds in 2017 for open tenders are up to US$48,000 for municipalities and US$72,000 for all other institutions.

to clearly specify that the use of COMPRASAL-II was mandatory and that it contained a master register of suppliers; (c) it did not include new types of contracting such as standard agreements or electronic auctions;[24] and (iv) the reverse auction system administered by the Salvadoran Goods and Services Exchange (BOLPROS) is not compulsory for central government institutions,[25] and the fees it charges on contract awards are a disincentive to its use.[26]

1.15 **Results-based budgeting (RBB) and medium-term expenditure framework (MTEF).** The current budget model based on management areas does not allow the funds allocated to be linked to the objectives, targets, and achievements for which they are intended. El Salvador does not have RBB or mechanisms for measuring spending efficiency.[27] No MTEF has been adopted that would permit NFPS institutions to set performance targets that extend beyond the annual budget. El Salvador adopted a budget reform plan based on four pillars: (i) replacement of the current budget model based on management areas (which stresses the allocation and use of inputs) by RBB (in which the focus is on the attainment of objectives and expected results of public programs); (ii) implementation of a MTEF and medium-term institutional frameworks (MTIFs);[28] (iii) creation of a system for monitoring and evaluating program performance; and (iv) development of capacity and commitment throughout the public sector.

1.16 To implement the reform, it was necessary to prepare regulations, concepts, and methodological instruments (manuals, guidelines, instructions, etc.) and to build new technical capacity in the Ministry of Finance's Budget Administration and throughout the NFPS. In parallel, it was necessary to ensure that the budget formulation and execution module of the new SAFI-II was capable of providing support and channeling the entire flow of information on the new processes and subprocesses in the budget cycle and integrating it with the system's other modules.[29]

1.17 **Public investment management and private investment facilitation.** Public and private investment levels are low at 14.1% of average GDP in 2011-2016 compared to 18.9% in the rest of the Northern Triangle countries, and 23.2% in Latin America (IMF, 2018b). Low investment limits potential growth, making measures to increase it necessary. Public investment management is inefficient owing to shortcomings and the lack of transparency in the public investment system (Armendariz et al., 2016). The main defects in the current system are strategic,[30] functional, operational,

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[24] The efficiencies, savings, and advantages that would stem from the better procurement practices followed in other national systems are an estimated 0.8% of GDP (IDB, 2016d).

[25] Just 30 of 376 institutions used this mechanism during 2013-2017 (BOLPROS, 2017).

[26] Extrapolating the average savings by ministries that used reverse auctions for their procurement in 2015 to all government agencies, the savings could be as high as 0.9 percentage points of GDP (ANEP, 2016).

[27] El Salvador scored below the average in the region in the RBB index (0.8 compared to 1.9) (Kaufman et al., 2015). The measurement is based on 2013 data.

[28] MTIFs are prepared by each institution in the NFPS and set out sector/institutional objectives and strategic planning priorities, physical and financial programming, and revenue projections for four-year periods. The MTEF is obtained as the result of the process of analyzing and consolidating the MTIFs, using the five-year development plan, the MLTFF, budget policy, and the medium-term institutional spending caps as references.

[29] SAFI-II also includes treasury, accounting, procurement, investment, and public credit modules.

[30] The investment system is not integrated with the budgeting system, which makes it difficult to allocate public spending and protect investment and social spending.

and organizational[31] in nature, which translate into inadequacies in the planning, identification, and project selection stages, low investment execution (65% of programmed investment),[32] and little ex post evaluation of the results of investment projects. El Salvador places second-to-last in the public investment efficiency index, with 1.7 out of a maximum of 4 points. The average for the Latin American countries evaluated is 2.4 (Armendariz et al., 2016).

1.18 Private investment facilitation is inefficient due to: (i) the complexity of establishing businesses and of the periodic obligations they must comply with,[33] the average cost of which is 41.1% of average per capita income and is higher than the average for Latin American countries (37.5%);[34] and (ii) the lack of public investment financing to spur private investment (USAID, 2012 and 2017), which is discouraged by inadequate public goods and services.[35]

1.19 **Management of tax collection and tax transparency.** The Ministry of Finance's organizational structure is inadequate to effectively collect overdue taxes. Recovery of the tax debt is 25% lower than the Latin American average and the debt is three times older (Inter-American Center of Tax Administrations (CIAT), 2016, and IDB, CIAT, IMF–Regional Technical Assistance Center for Central America, Panama, and the Dominican Republic (CAPTAC-DR), 2012). Integration with third-party databases is limited and cross-referencing is ad hoc. The collection function is crucial for the efficiency of a tax administration. In El Salvador, the process is weak due to its institutional segmentation in the Office of the Attorney General (FGR) and the Treasury Administration (DGT), which in turn is poorly coordinated with the Internal Revenue Administration (DGII) and the Customs Administration (DGA). A moratorium can be useful to support collections management to regularize tax status, targeted to specific groups. Measures such as waiving fines, surcharges, and interest on arrears in administrative proceedings or court litigation, and the remission solely of interest on arrears on tax bills declared final and due have been successful when implemented for a short, clearly-defined period, and accompanied by measures to improve tax control (OECD, 2015). Accordingly, closer coordination between the DGT, the DGII, and the DGA should be accompanied by better access to the databases of the main public registers so that periodic information can be cross-referenced for more effective tax control.[36]

1.20 El Salvador does not share tax information with other jurisdictions automatically or on request. A legal vacuum also exists that makes it impossible to determine the ultimate beneficial owner of property, which weakens attempts to combat international tax evasion and fraud. El Salvador is a commercially-open and financially-integrated economy which means it is important to mitigate the

[31] USAID, 2012.

[32] Investment and Public Credit Administration (DGICP), 2018.

[33] Regulatory Improvement Agency (OMR), 2017.

[34] World Bank, 2018.

[35] A survey of 200 companies in different productive sectors showed that investment is influenced by: burdensome government regulations and procedures relating to economic activity; deficiencies in the provision of public goods to facilitate private investment; poor efficiency in sectors that are key for competitiveness; shortage of skilled workers; and insufficient or defective logistics infrastructure (USAID, 2011).

[36] IMF, 2014.

reputational risks that could affect its commercial and financial standing through proper implementation of the standards of transparency and exchange of information in the tax area developed by the Global Forum on Transparency and Exchange of Information for Tax Purposes. El Salvador put an end to banking secrecy in tax matters and abolished bearer share companies prior to joining the Global Forum and has undertaken to comply with the standards (OECD, 2016).

1.21 **Reform of the pension system.** The pension reform passed in 2017 establishes the institutional framework for addressing the challenges described here. Prior to the reform, the SAP Act did not consider longevity risk or strongly regressive low replacement rates. The institutional framework required to ensure that pension decisions had a sound technical foundation that reflected real developments in the system did not exist. In the absence of reforms, the pension system posed a fiscal challenge, since it would demand more and more fiscal resources (due to the increases in the minimum pension and the pension guarantees for contributors opting to migrate to the SAP), rising to 3% of GDP in 2024 (Melinsky, 2017). Between 2009 and 2016, the government transferred an annual average of 1.8% of GDP to cover pension obligations, administrative costs, and redemption of transfer certificates held by workers in the old SPP, and those who opted into the new system. Combined with the fiscal problems, the pension system faced two additional challenges. First, the system did not fulfill its basic purpose of providing stable pensions that would cover the longevity risk. Specifically, there were no lifetime pensions but rather programmed retirements that could vary in length. Furthermore, the SAP pensions only replaced between 35% and 40% of the wage, partly because of the low returns on pension savings[37] and the cost of administering the funds,[38] and because the contribution rate was not high enough to finance larger pensions (Méndez et al., 2015). The system also granted regressive benefits, since for higher-income workers the replacement rate exceeded 70%—significantly higher than the regional average—which entailed an implicit unfunded subsidy (Bosch, 2018). Second, no institutional framework was in place to ensure that future policy decisions would have a sound technical foundation that reflected real developments in the system. Future decisions with political and short-term motives could lead to fiscal commitments that would be unsustainable over the long term.[39]

1.22 **Bank experience in the country.** The Bank has been cooperating with and promoting the process of strengthening public finance in El Salvador for a number of years, particularly the policy reforms presented in this operation. The Bank provided technical assistance for designing a legal framework for fiscal accountability, preparing draft legislation, and promoting dialogue and discussion among relevant political stakeholders to promote the regulations approved in

[37] The average interest rates accrued by pension investment certificates (CIPs) are lower than the market rates for sovereign securities with similar conditions, jeopardizing the return on employees' savings. CIP A and CIP B, which must be purchased from the FOP, earned an average of 1.9% and 2.19% in 2016, respectively, compared to the approximately 8% that the government paid for comparable obligations on international markets. This difference makes it impossible to put off an increase in the returns paid on the certificates to improve individual pension earnings (Iniciativa Ciudadana para las Pensiones, 2017).

[38] Fees and insurance contracts could be reduced from 2.2% to 2% over a 10-year period (Melinsky, 2017).

[39] IDB simulations of the region's pension systems indicate that the institutional framework plays a key role in controlling fiscal costs and protecting the system from political pressure (Bosch, 2018).

November 2016. It also supported better public debt management and adoption of the first medium-term fiscal framework (MTFF) in El Salvador.[40]

1.23 The Bank supported the search for alternatives reforms to make the pension system financially sustainable.[41] It also provided technical assistance for El Salvador's Office of the Superintendent of the Financial System (SSF) in projecting the fiscal costs of the public pension programs and financed studies and training to enhance actuarial skills for developing reform proposals. In addition, it made recommendations, some of which were incorporated into the reform, including strengthening the system's institutional framework and improving its equity.[42]

1.24 Since 2013, the Bank has provided technical assistance to boost the efficiency of spending through studies on staffing and wages in El Salvador and comparable countries between 2007 and 2013, which have focused on the civil service and specialized careers in health care, education, and security. It also supported the Technical Secretariat of the Office of the President (STP) in designing and implementing payroll audits.[43]

1.25 The Bank supported the use of efficient electronic procurement models through the technical design of COMPRASAL-II and institutional strengthening for the UNAC and has built financial, technical, and organizational capacity in micro, small, and medium-sized enterprises to increase their participation the electronic procurement systems.[44]

1.26 Through PRODEV, the Bank offered the country technical assistance in developing a conceptual model for public management by results, provided advisory support on the processes of budget formulation, execution, monitoring, and evaluation in four government institutions, and finalized the technical design of the national planning system.[45]

1.27 It also supported investment project management to boost budget execution capacity for complying with disbursement targets, with a view to attaining the country's development goals.[46]

1.28 Support for making the tax administration more efficient in El Salvador has been broad in recent years. Technical cooperation projects to support fiscal management have strengthened the direction of economic and fiscal policy and tax and customs modernization, creating the Office of the Deputy Minister of Revenue (VMI), and

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[40] ATN/FI-12988-ES, ATN/FI-15360, ATN/FI-12417-ES, ATN/KM-10650-ES, ATN/SF-9888-ES, and 2269/OC-ES.

[41] ATN/OC-13798-ES provided crosscutting support for creating a database for discussion of the pension reform, which provided information on labor transitions between the formal and informal sectors, and members' views and expectations of the system. The Office of the President's Technical Secretariat (STP) published a diagnostic analysis of the pension system based on data from the longitudinal survey of social protection.

[42] ATN/SF-11951-ES, ATN/OC-14802-ES, and ATN/OC-15675-ES.

[43] ATN/FI-14338-RG and ATN/AA-15681-RG.

[44] ATN/OC-16234-ES, ATN/ME-13302-ES, and ATN/ME-10542-ES.

[45] ATN/OC-9852-ES and ATN/OC-11266-ES.

[46] ATN/SF-11363-ES and ATN/OC-15728-ES.

establishing the Large Taxpayer Unit and the collections unit.[47] In 2017, a program to strengthen the tax administration was approved, which complements the technical cooperation project to support strengthening of the tax administration and fiscal policy for inclusive growth, both of which support and supplement this operation.[48]

1.29 **Bank experience in the sector.** This program is part of the support that the Bank has provided to other countries in their reform processes to improve tax administration and the quality of public spending and strengthen fiscal sustainability. The most recent policy-based loan programs in these areas include the Fiscal Consolidation Support Program in Honduras (3590/BL-HO), the Public Finance Strengthening Program in Mexico (3201/OC-ME, 3676/OC-ME), and the Program to Support Transparency and Integrity Reforms in Argentina (4244/OC-AR). The Bank's support in these areas is also supplemented by investment operations: the Public Financial Management and Performance Monitoring Reform program in The Bahamas (3340/OC-BH), the Program to Enhance the Efficiency of Tax Administration and Public Expenditure Management in the Dominican Republic (4114/OC-DR), the Public Sector Efficiency Program in Jamaica (3121/OC-JA), the Project to Boost Efficiency in Public Investment Management and Public Procurement in Peru (4428/OC-PE), and the Fiscal Strengthening to Support Economic Growth Program in Suriname (4112/OC-SU).[49] In the area of pensions, the Bank has supported various reforms with similar characteristics, including Support for Health Sector and Social Security Consolidation in the Dominican Republic (3326/OC-DR, 3585/OC-DR), Fiscal Consolidation Support Program in Honduras (3590/BL-HO), and the Fiscal Structural Programme for Economic Growth in Jamaica (3511/OC-JA).

1.30 **Lessons learned.** The lessons learned from the Office of Evaluation and Oversight's (OVE) Country Program Evaluation: El Salvador 2009-2014 and monitoring its recommendations related to the fiscal area as input for the IDB Country Strategy with El Salvador 2015-2019 were incorporated into the design of the operation, such as: promoting policy measures for fiscal sustainability; not allowing budget support objectives to take precedence over reform objectives; and supporting the sustainability of the pension system and preparation of the LRF. This program has also drawn on lessons learned from Bank experience in the sector (paragraph 1.29) and was based in technical inputs stemming from technical cooperation projects (paragraphs 1.22 to 1.28), given the existing complementarity between those projects, the investment projects, and policy-based loan programs.

1.31 The lessons learned relating to the pension and fiscal areas include ongoing dialogue with the government to anticipate possible demands, through technical cooperation projects, with sufficient flexibility to respond to short-term requests, while persisting on key recommendations. The reforms incorporate Bank recommendations after years of dialogue with the country.

1.32 Another lesson learned is the importance of technical coordination among donors to create synergies and avoid duplication, as in the round table of donors who support

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[47] ATN/SF-11956-ES, 2296/OC-ES, ATN/SF-11796-ES, 2710/OC-ES, and ATN/FI-15360-ES.

[48] 3852/OC-ES and ATN/OC-16234-ES.

[49] Further details on Bank operations in the areas of fiscal management, taxation, and tax administration can be found in the Fiscal Policy and Management Sector Framework Document (document GN-2831-3) (IDB, 2016).

fiscal policy. Constructive technical coordination was established with the IMF, the World Bank, and USAID in designing this operation. Diagnostic analyses prepared by these institutions, the OECD, and the Millennium Challenge Corporation related to specific aspects of this operation were also used.

1.33 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy Update (UIS) 2010-2020 (document AB-3008) and is aligned with the challenge of Social Inclusion and Equality, through the inclusion of a clause in the 2018 Budget Act that declares budget allocations to finance social programs to benefit women, children, other vulnerable groups, and the poor nontransferable, and promotes intergenerational equity through pension reform. It is consistent with the development challenge of Productivity and Innovation through promotion of the implementation of COMPRASAL-II and the development of the budget formulation and execution module for SAFI-II. The program is also aligned with the crosscutting area of Institutional Capacity and Rule of Law, through its promotion of the approval and entry into force of legal, regulatory, and operational instruments to improve tax management, heighten the efficiency of public spending, and strengthen fiscal sustainability. The program will contribute to the Corporate Results Framework (CRF) 2016-2019 (document GN-2727-6) through the indicators for government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery, and countries benefitting from IDB projects to improve the mobilization of domestic resources. It is also aligned with the objectives of the Country Strategy with El Salvador 2015-2019 (document GN-2828) since it will strengthen fiscal sustainability, increase the efficiency and equity of public spending, and improve the effectiveness of investments by prioritizing projects with high social returns. It is included in 2018 Operational Program Report (document GN-2915).

1.34 The program is consistent with: (i) the Sector Strategy: Institution for Growth and Social Welfare (document GN-2587-2), since it helps strengthen tax management, public spending, and fiscal sustainability; (ii) the Fiscal Policy and Management Sector Framework Document (document GN-2831-3), since it promotes policies and actions to reinforce fiscal sustainability, boosting the efficiency of tax administration and the use of public resources, and laying the groundwork for the mobilization of private investment for higher growth; and (iii) the Labor Sector Framework (document GN-2741-7), since it prioritizes the sustainability of the pension system. This operation is aligned with the Plan of the Alliance for Prosperity in the Northern Triangle, since it provides for institutional strengthening while improving the financial capacity of the State.

B. Objectives, components, and cost

1.35 **Objective.** The objective of this programmatic series and of this first operation is to strengthen fiscal sustainability, protecting public investment and social program funding to favor inclusive growth. The specific objectives are to: (i) boost the efficiency of fiscal management (with particular emphasis on the efficiency of public expenditure); and (ii) improve pension sustainability.

1.36 The program as a whole includes 8 laws, 11 regulations, manuals and operating rules, and 23 implementation actions. The policy conditions of this first programmatic operation include the passage and implementation of six laws and actions to develop and strengthen the institutional capacity of the government procurement system,

RBB, the MTEF, the public investment system, and the management of tax collection and tax transparency. This set of actions strikes an adequate balance between policy formulation and implementation. The second operation will seek to consolidate the reforms as far as possible through gradual implementation of the LRF and the regulation and implementation of the SAP act, as well as the deepening of other policies adopted in the first operation.

1.37 **Beneficiaries.** This project benefits the Salvadoran government, particularly the Ministry of Finance, through improvements in all areas of public financial management, which will contribute to its consolidation. It also benefits all Salvadorans by protecting vulnerable groups (women, children, and older adults) through the promotion of inclusive growth and by improving the country's fiscal position through greater efficiency and transparency in managing public spending and tax collection that will result in potential savings. The program is structured in the following components.

1.38 **Component I. Macroeconomic stability.** The objective is to ensure that the macroeconomic context is consistent with the program's objectives, as established in the Policy Matrix (Annex II).

1.39 **Component II. Policy reforms and management of public expenditure and revenue.** The objective is the passage of legal policy and fiscal management instruments to strengthen fiscal sustainability and efficiency.

1.40 **Macrofiscal management.** To improve management of fiscal policy sustainability and its institutional framework, which will contribute to the fiscal balance in the medium and long terms, the first operation in this programmatic series establishes the following policy measures: (1) passage and entry into force of the LRF which establishes: (i) fiscal rules that set caps on the primary balance and public debt (main elements recommended in modern fiscal rules, Kumar et al., 2009); and (ii) creation of a medium- and long-term fiscal framework (MLTFF); (2) publication of the MLTFF (2017-2027) which sets fiscal targets to guide a period of consolidation intended to stabilize the debt (paragraph 1.11). The MLTFF should also include a broad overview of public finances through a 10-year projection of a series of fiscal aggregates and indicators, including projections of income, expenditure, and debt levels; a public investment program and its financing; a report on subsidies spelling out their amount and socioeconomic impact, and the obligations backed by the State; (3) inclusion of measures in the 2018 budget to comply with the LRF by: (i) prohibiting the creation of positions not provided for in the budget, new economic benefits for public employees, and the purchase of extravagant goods and equipment; and (ii) declaring budget allocations to finance social programs nontransferable; and (4) strengthening of processes and internal controls on payroll spending in the Ministries of Education and Health and the National Water and Sanitation Administration, through studies on optimizing payrolls, with recommendations to make their management more efficient.

1.41 The second operation will provide for: (1) fulfillment of measures consistent with the primary balance targets (≥0% of GDP) and the NFPS pension debt (≤65% of GDP) established in the LRF to be included in the 2019 budget; (2) publication of the MLTFF-2018-2028 as established in the LRF; (3) inclusion of measures in the 2019 budget to comply with the LRF, i.e.: (i) current expenditure (excluding pensions) below 18.5% of GDP; and (ii) declaration that budget allocations earmarked for

social programs are nontransferable; and (4) strengthening of processes, information tools, and internal controls on payroll spending, through the development of an electronic payroll to support the operations management processes of central government institutions.

1.42 **Government procurement management.** To upgrade digital systems and the regulatory framework for managing government procurement, the first operation provides for: (1) implementation of an electronic procurement portal (COMPRASAL-II), starting with the open tenders module, through: (i) approval and entry into force of measures making it compulsory for all NFPS institutions to gradually migrate to COMPRASAL-II; (ii) approval of operating rules for the COMPRASAL-II open tenders transaction module; and (iii) training in and implementation of the module in at least 15 public sector institutions; and (2) elimination of the use of brokers for central government institutions in the reverse auctions administered by BOLPROS, with a view to increasing use of this mechanism, which has resulted in significant savings for agencies that have used it.

1.43 The triggers for the second operation include: (1) implementation of the COMPRASAL-II public procurement module by: (i) developing the second transaction module for competitive bidding in COMPRASAL-II; (ii) approving the operating rules for procurement using the COMPRASAL-II competitive bidding transaction module; and (iii) providing training in and implementing the open tender module in COMPRASAL-II in at least 30 public sector institutions; and (2) preparation and submission to the Legislative Assembly of amendments to the Government Procurement Act (LACAP) to incorporate efficient and transparent contracting mechanisms, including the compulsory use of electronic reverse auctions, framework agreements, or electronic catalogues.

1.44 **Results-based budgeting (RBB) and management of the medium-term expenditure framework (MTEF).** For better RBB and management of the MTEF, the first operation provides for a policy action to replace the existing budgeting system, which is currently structured into management areas, with a new RBB system and implement a MTEF to improve the quality of spending through: (i) training for the employees responsible for the budget and planning in 100% of public sector institutions, in accordance with the training and technical assistance plan for implementation of the budget system reform, which will provide them with the skills and technical capacity necessary to carry out their new duties effectively; (ii) development of at least 95% of the budget formulation and execution modules in the new SAFI-II; (iii) preparation of pilot plans for a medium-term institutional framework (MTIF) in at least five institutions, which will include the draft institutional budget and physical and financial programming for four years—the pilot plans will enable a start to be made on implementing the MTIF manual that has already been approved and on using the skills learned during training to prepare this document in each public institution; and (iv) approval of a new edition of the Public Sector Financial Transactions Classification Manual, to be used as the basis for formulating and executing RBB.

1.45 The second operation plans to support replacement of the system of budgeting by management areas through: (i) approval of RBB in 100% of public sector institutions, which will directly link budget allocations to their objectives; (ii) implementation of the

budget formulation and execution modules in the new SAFI-II (when this module becomes operational, it will channel the entire flow of information from the new budgeting system, gradually integrating it with the other modules); (iii) approval by 100% of central government institutions of a MTIF which, in the future, will serve as input for preparing the MTEF and the general government budget; and (iv) submission to the Legislative Assembly of draft amendments to the Government Financial Administration Act, establishing mechanisms for planning, programming, execution, and evaluation of the new budgeting system, and making use of SAFI-II, the MTIF, and the MTEF compulsory.

1.46 **Public investment management and private investment facilitation.** To strengthen the management of public investment, reduce the costs of business formalities, and facilitate logistics to leverage private investment, the policy actions in the first operation will be: (1) improvement of the system for public investment management by coordinating investment projects with the new RBB system, which includes pilot projects with at least four central government institutions, as well as progress in preparing the conceptual and functional model for the public investment system; (2) simplification of administrative procedures for businesses through: (i) publication of the Regulatory Improvement Agency's (OMR) operations manual[50] and (ii) signature of plans to simplify procedures (regulatory improvement) for companies in at least five public institutions,[51] which will make it possible to identify, simplify, and improve regulations that currently represent obstacles for establishing companies and make recurring business operations difficult; and (3) implementation of an Investment Promotion Fund (API) through: (i) approval and publication of instruments governing the API and (ii) signature of at least two agreements with private sector enterprises.

1.47 The second operation calls for: (1) approval of the macroprocess of managing public investment, including its conceptual and functional definition; (2) simplification of public sector administrative procedures by: (i) drafting and submitting an administrative procedures bill to the Legislative Assembly and (ii) implementing the plans for regulatory improvements in five public sector institutions; and (3) signature of at least two additional agreements with public sector companies under the API.

1.48 **Management of tax collection and tax transparency.** To improve the management of collections, the first operation includes: (1) implementation of a program to strengthen collections management, the information system, and tax control through: (i) the creation of a Tax and Customs Arrears Collection Division (DCTA) to handle collection for the DGII and the DGA, in coordination with the Office of the Attorney General's Internal Revenue Appeals Court, to enhance the effectiveness of collection;[52] (ii) signature of agreements with the National Citizen Registry (RNPN), the Salvadoran Social Security Administration (ISSS), and the Salvadoran Agency for the Promotion of Cooperatives (INSAFOCOOP) for cross-referencing data in their records with information in the DGII and DGA databases,

[50] The Regulatory Improvement Agency has been established to improve the investment climate in the country, focusing on public policies to facilitate optimum functioning of economic activities, through the formulation of clear, simple, efficient, and transparent regulations.

[51] Ministry of the Interior, Ministry of Health, Ministry of Economy, Ministry of Finance, and Ministry of Labor.

[52] The DCTA has the authority to order that payments be withheld from debtors and make provisional claims (seizure or attachment) on assets such as moveable and immovable property and bank accounts.

which will help to make more tax information available and improve taxpayer control; and (iii) passage and entry into force of a temporary law to facilitate voluntary compliance with tax and customs obligations, to regularize the status of taxpayers with fiscal debts, which will improve tax debt recovery levels; and (2) inclusion of El Salvador as a full member of the Global Forum on Transparency and the Exchange of Information for Tax Purposes and compliance with the standard for the exchange of tax information on request by other member jurisdictions to strengthen tax transparency. This may involve financial, accounting, or ownership information (i.e. information on the identity of beneficial owners). To comply with this standard, the country guarantees integrity and confidentiality in the treatment of the information transmitted and commits to providing the information requested by another jurisdiction within deadlines established based on the complexity of the request.

1.49 The second operation will: (1) strengthen the Ministry of Finance's collections management, information system, and tax control by: (i) starting up the DCTA through the establishment of a risk management system for tax and customs debts; and (ii) signing an agreement with the National Registry Center (CNR), implementing the agreements reached, and integrating the databases of public agencies (the RNPN, the CNR, the ISSS, and INSAFOCOOP) with the Ministry of Finance's Internal Revenue, Customs, and Treasury Administrations; and (2) prepare a bill on compliance with the Global Forum's ultimate beneficial ownership standard for transparency and exchange of information.

1.50 **Component III. Pension system reform.** The objective of this component is institutional strengthening of the pension system to attain long-term stability, provide lifetime pensions, and improve intergenerational equity. The first programmatic operation will support the passage and entry into force of the SAP Act and the Pension Trust Fund (FOP) Act which provide for: (i) a change in the contribution rate (for employees and employers) from 13% to 15%; a reduction in payments for disability and survivor insurance and in the fees charged on individual accounts managed by the pension fund administrators (AFPs) from 2.2% to 1.9% in 2022; and an increase in the interest rate on pension investment certificates (CIPs) from 2.6% to 6% (these adjustments in parameters will enhance sustainability and ensure that future pensioners have longer pensions); (ii) creation of longevity insurance to ensure continuous and permanent income for old-age pensioners and survivors, and creation of a Solidarity Guarantee Account to finance the longevity insurance; (iii) establishment of a risk committee to determine investment caps for the different types of instruments and minimum risk ratings for the instruments invested in the pension funds, and creation of an actuarial committee to determine minimum pension amounts, review life expectancy for determining the retirement age, and review the adequacy of the Solidarity Guarantee Account—these committees will strengthen the system's institutional capacity to make decisions that promote fiscal sustainability; and (iv) modification of pension benefits through the following measures: (a) cap of US$2,000 on the maximum monthly benefit for SPP pensioners; (b) incorporation of a maximum pension of 55% of the wage into the pension-calculation formula for workers who migrated from the SPP to the SAP; and (c) a reduction in disability and survivor pensions from 70% to 50% of the wage. These measures will help to reduce intergenerational inequality by paying a steady lifetime pension to future pensioners, improving pension savings for future generations of workers through a higher contribution rate and higher returns, and

lower management fees. They will promote fiscal savings by limiting the regressive benefit of a maximum monthly pension for this generation of SPP pensioners.

1.51 The second programmatic operation will support implementation of the measures designed in the first operation, in particular the SAP and FOP regulations, through: (i) implementation of an increase in the contribution rate from 13% to 15% to remain in effect for one year, implementation of the reduction in the cost of disability and survivor insurance and the administration fee, and issue of CIPs at the new interest rate of 6%; (ii) preparation of regulations governing longevity insurance, including regulation of the Solidarity Guarantee Account to finance that insurance; (iii) preparation of regulations governing the operations of the risk committee and design of a regulatory framework for the establishment of an actuarial committee to determine the size of minimum pensions, review life expectancy to determine retirement ages, and review the adequacy of the Solidarity Guarantee Account; and (iv) implementation of the changes in pension benefits for SPP pensioners, pensioners who migrated from the SPP to the SAP, and disability and survivor pensioners.

C. Key results indicators

1.52 A results matrix was prepared to measure the impact and outcomes of the program's policy and reform activities. The outcomes will be monitored and evaluated by agreement with the borrower.

1.53 The expected impacts are: (i) a reduction in the primary fiscal balance which averaged -1.2% of GDP in 2013-2015 to 0.3% of GDP in 2019; (ii) an increase in public investment from 2.4% of GDP in 2017 to 2.8% in 2019; and (iii) an increase in average GDP growth from 1.8% for the period 2013-2015 to 2.3% in 2019. The main expected outcomes are: (i) stabilization of current expenditure from an average of 18.7% of GDP in 2013-2015 to 18.5% of GDP in 2019; (ii) an increase in the total amount of procurement through COMPRASAL-II from 0% in 2017 to 7% in 2019; (iii) an increase in tax arrears collected during the moratorium from 0% of the total tax debt in 2016 to 15% in 2019; (iv) a reduction in total spending on pensions financed through the FOP from 2.0% of GDP in 2017 to 1.6% of GDP in 2019; and (v) an increase in nominal returns (net of the management fee) from the "conservative fund"[53] from 3.8% in 2017 to 4.8% in 2019.

1.54 **Economic analysis.** Based on OVE's recommendation in its 2011 Evaluability Review of Bank Projects,[54] and in the review of practices and standards of evaluation of policy-based loans by the Evaluation Cooperation Group (ECG, comprising the independent evaluation offices of the multilateral development banks),[55] envisaged in paragraph 1.3 of document GN-2489-5 (Review of the Development Effectiveness Matrix for Sovereign Guaranteed and Non-Sovereign Guaranteed Operations),

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[53] Employees can choose among four investment funds. The "conservative fund" establishes a maximum investment in variable yield securities of 20% so that changes in securities markets will not have a significant impact on the value of pension savings.

[54] Document RE-397-1: Currently, the economic analysis section is computed as the maximum between the cost-benefit analysis and the cost-effectiveness analysis, yet neither analysis is applicable to policy-based loans.

[55] Good Practice Standards for the Evaluation of Public Sector Operations. Evaluation Cooperation Group. Working Group on Public Sector Evaluation. 2012 Revised Edition. February 2012.

which included an indication that it would not be necessary to include an efficiency analysis in the use of financial resources,[56] it was determined that an economic analysis would not be carried out, and therefore, the economic analysis is not considered for purposes of the evaluability score in this program's DEM.

1.55 **Internal and external validation.** The effectiveness of the measures proposed in this program and their corresponding impacts and outcomes are supported by abundant evidence in the economic literature. Fiscal rules have proven to be effective in improving fiscal balances (Badinger and Reuter, 2017). As for medium-term fiscal frameworks, countries that have medium-term budget projections improve their fiscal balances by about two percentage points of GDP (Vlaicu et al., 2014). Payroll audits have contributed to significant efficiencies in the public sector. In Brazil, they resulted in annual savings of US$111 million at the state level (World Bank, 2012) and US$150 million at the federal government level (Controladoria Geral da União, 2015). Computerization of the payroll has the benefit of reducing leakages of public funds, eliminating fraudulent payments, and reducing payment processing costs, which could lead to savings of about 1% of GDP in developing countries (Gupta et al., 2017). Inefficiencies in investment processes average about 30% and the growth dividend of closing this inefficiency gap is considerable: a 1% increase in public investment causes GDP growth of just 0.3% in countries in the lowest efficiency distribution quartile, but the figure for countries in the highest quartile is 0.6% (IMF, 2015). The improvement in fiscal balances is also linked to higher economic growth (Adam and Bevan, 2005; Lee, Park, Seo, and Shin, 2017). Moreover, countries with better regulations grow faster (Djankov et al., 2006).[57] The fact that measures of this kind spur growth is important for fiscal sustainability.

1.56 As for the proposed results, Latin America has many success stories in the use of portals for government procurement and in the contracting mechanisms proposed by the program. In Chile, use of the e-procurement system is estimated to have reduced procurement costs by an average of 2.65% in 2007 and it also reduced administrative costs by 0.28% and 0.38% in 2006 and 2007 (Singer et al., 2009). In Paraguay, implementation of the government procurement system made for savings in procurement that averaged US$38 million a year (Mejía and Garay, 2012). The way in which a government formulates and executes its budget affects the impact of public policies. In contexts where results-measurement systems are strengthened, the information can be used to improve productive efficiency and the allocation of resources in budgets (Robinson and Bruni, 2005). Adoption of an MTEF has a significant impact on fiscal discipline. Moving from a framework that only contains macroeconomic projections to one that includes spending priorities brings about an improvement in the fiscal balance ranging from 0.9 to 2.8 percentage points of GDP (Brumby et al., 2013). Moratoriums can increase tax revenues, net of administrative costs, in the short term (Langenmayr, 2015). With regard to pensions, projections for pension expenditures financed through the FOP were prepared using the annual

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56 According to the ECG, PBLs can be evaluated in terms of relevance, effectiveness, and sustainability. Efficiency was not included as a criterion, since the size of the PBL is related to a country's financing gap, independent of the project's benefits.

57 The study uses business regulation measures in 135 countries and estimates that moving from the lowest to the highest quartile for business regulation leads to an average increase of 2.3 percentage points in the annual growth rate.

pension deficit as an input and included the impact of financing pension spending through debt offerings (IDB, 2018 and Melinsky, 2018). Changes in pension contribution parameters and reductions in benefits for groups with very high pensions can improve the system's financial stability (OECD, 2014). Lastly, the projections for fund returns were based on direct calculations of the reform, which increases returns on CIPs from 2.6% to 6%, an increase of 3.4 percentage points.[58] Higher returns on funds are crucial for improving pensions (Bosch et al., 2015).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financing instrument.** This operation has been structured as a programmatic policy-based loan (PBP) and represents the first operation in the series, which will consist of two loans that are contractually independent but technically linked, as established in document CS-3633-1 on the preparation and implementation of PBPs. The programmatic modality was chosen because it provides flexibility to adapt to new events or new knowledge acquired during execution.

2.2 **Amount and currency.** This first operation is for US$350 million from the Bank's Ordinary Capital. It will cover the country's broad fiscal resource needs, supporting deep fiscal reforms (paragraph 3.27(b) of document CS-3633-1). The proceeds will be disbursed in a single tranche, which is justified by the country's financing requirements for maintaining a stable macroeconomic framework. El Salvador's NFPS financing requirements for 2018 are estimated to be about US$528 million. This operation represents 66% of those requirements and of the anticipated external financing. The amount and date of the second operation will be agreed upon with the government in consideration of progress in complying with the triggers and the Bank's programming exercise with the country.

B. Environmental and social risks

2.3 The operation supports the definition of policies, rules, management tools, and other institutional strengthening actions, and therefore no socioenvironmental risks are anticipated. Pursuant to Directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), this program does not require classification.

C. Fiduciary risks

2.4 No fiduciary risks associated with the operation have been identified. First, the financial instrument does not include procurement and second, the proceeds of this operation will be disbursed directly into the Master Treasury Account to cover financing requirements, and the executing agency has the necessary financial management instruments and control systems. The proceeds will be disbursed once the policy measures established in the loan contract have been fulfilled.

[58] CIPs account for 61.3% of the total AFP portfolio (SSF, 2017). An increase of 3.4 percentage points on 61.3% of the portfolio should increase returns by 2.1 percentage points, and therefore the projected results are conservative estimates.

D. Other project risks

2.5 **Fiscal sustainability risk.** This moderate risk is linked to the possibility of an international or regional crisis that would lead to a sudden stop in the inflow of capital, a substantial increase in oil prices, or a natural disaster, each of which would have a negative impact on the fiscal balance. Although this risk cannot be completely controlled, the set of measures promoted by the program will help mitigate the potential impacts. In addition, the loan will cover the 2018 budget gap, for significant savings over the cost of obtaining financing on the international market.

2.6 **Public management and governance risks.** Three moderate risks have been identified. The first is that the lack of technical capacity and/or opposition by affected groups could stand in the way of implementing the standards on transparency and the exchange of tax information agreed upon with the Global Forum. To mitigate this risk, the Ministry of Finance has agreed on an assistance plan with the Coordination Group (composed of the World Bank, the IDB, CIAT, the German Agency for International Cooperation, and the OECD) for scheduled compliance with its commitments to the Global Forum. In addition, the Ministry of Finance maintains communication with the private sector, disseminating the advantages of joining the international tax transparency process and of the drawbacks in the commercial, financial, and reputational fields of being viewed as a jurisdiction that does not comply with the commitments contracted with the Global Forum and the Financial Action Task Force.

2.7 The second risk is that due to the lack of technical capacity, coordination problems, and/or resistance to the reform by the affected sectors, delays and operational difficulties may arise in implementing the pension reforms. To mitigate this risk, the SSF is receiving assistance in building technical capacity to ensure compliance with the commitments established in the Policy Matrix. The Pension System Technical Committee, which reports to the STP, will continue to receive support to strengthen interagency coordination. A communication campaign has been planned to explain the reasons why pension adjustments are necessary to achieve greater intergenerational equity and make the system financially sustainable. In addition, all proposed adjustments will be submitted for analysis to the actuarial committee to assess their fiscal feasibility, in order to avoid pension reductions.

2.8 The third risk is related to the possibility of a change in political priorities that leads to delays in implementing the reforms supported by the program. This risk is mitigated by the fact that the government and the opposition have reached major agreements on stabilizing the fiscal accounts and spurring the economy, the LRF, pension reform, and the 2018 budget that this program supports. In addition, approval of the MLTFF (which reflects the policies and reforms intended to maintain the fiscal balance) coupled with the budget passed by Congress, reaffirms this commitment year to year.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower.** The Republic of El Salvador through the Ministry of Finance.

3.2 **Executing agency.** The Ministry of Finance will bear technical responsibility for execution and undertakes to: (i) maintain itself or assign responsibility for maintaining official communication with the Bank and submitting reports and evidence of compliance with the conditions of the operation, and any other reports that are required, pursuant to the agreed time frames and conditions; (ii) promote actions to attain the policy objectives established in the program; and (iii) compile, file, and provide the Bank with all information, indicators, and parameters, that contribute to monitoring, measuring, and evaluating the program's results.

3.3 The Ministry of Finance will bear responsibility for coordination to carry out the measures called for in the programmatic series and will coordinate with the Investment and Public Credit Administration (DGICP) in compiling the necessary information. The Ministry of Finance will use the institutional means at its disposal to ensure effective coordination among public agencies related to the policy measures included in this operation. It will also cooperate with the Bank in coordinating measures that are part of this operation with other related bodies.

3.4 **Special contractual condition precedent to the sole loan disbursement: Compliance with the policy reform conditions as established in the Policy Matrix (Annex II), the Policy Letter, and the remaining conditions established in the loan contract will be a special contractual condition precedent to the sole loan disbursement for the first operation in the series.**

B. Summary of arrangements for monitoring results

3.5 **Monitoring.** Program monitoring involves verification of the agreed policy measures (Monitoring and Evaluation Plan). The Ministry of Finance and the Bank will hold periodic meetings to monitor the results of the operation and resolve technical difficulties associated with its execution. The Ministry of Finance will provide the Bank with the all information required to measure compliance with the program's targets in a timely fashion.

3.6 **Evaluation.** The evaluation strategy will have two parts. The first involves program monitoring to be performed through official reports, including detailed information and evidence of compliance with the program's conditions. The second covers the ex post program evaluation. The main questions to be included in the evaluation will address attainment of the desired impacts and outcomes in terms of fiscal sustainability (Monitoring and Evaluation Plan). A project completion report (PCR) will be prepared when execution of the programmatic series is complete.

IV. POLICY LETTER

4.1 The Policy Letter reiterates the commitment of the Salvadoran government to the objectives and actions included in the set of programmatic operations and to maintaining consistent national policies to strengthen fiscal sustainability for inclusive growth.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Social Inclusion and Equality -Productivity and Innovation -Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)* -Countries benefited by IDB's projects aimed at improving domestic resource mobilization (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2828**	**i) Strengthen fiscal sustainability; ii) Improve the efficiency and equity of public spending; iii) Improve the effectiveness of investement by prioritizing projects with high social returns.**
Country Program Results Matrix	**GN-2915**	**The intervention is included in the 2018 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		**Evaluable**
3. Evidence-based Assessment & Solution	**9.6**	
3.1 Program Diagnosis	**3.0**	
3.2 Proposed Interventions or Solutions	**3.6**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**N/A**	
5. Monitoring and Evaluation	**7.0**	
5.1 Monitoring Mechanisms	**1.1**	
5.2 Evaluation Plan	**6.0**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, Internal Audit. Procurement: Information System, Comparison.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

This is the first operation of the two that comprises this Programmatic Loan to Support Policy Reforms (PBP). This PBP consists of two contractually independent and technically linked loans.

The objective is to strengthen fiscal sustainability, protecting public investment and financing social programs, to promote inclusive growth. The specific objectives are: (i) to improve the efficiency of fiscal management, with special emphasis on the efficiency of public spending and (ii) to improve the sustainability of the pension system.

The diagnosis presented indicates the main problem as low fiscal sustainability. The specific problems identified are: (i) inadequate macro fiscal management, (ii) low efficiency in public procurement management, (iii) inadequate budget management, (iv) inefficiency of public and private investment management, (v) low efficiency of collection management and low tax transparency, and (vi) increasing demand for fiscal resources for the pension system.

The main causes of these problems are: (i) lack of fiscal rules, (ii) deficiencies in the legal, operational and technological framework for public procurement processes, (iii) lack of a budget model based on results, (iii)) strategic, functional and operational shortcomings in the management of public and private investment (iv) inadequate organizational structure for debt collection and (v) absence of an institutional framework to undertake reforms for a sustainable pension system.

The main beneficiaries, the citizens of El Salvador, are clearly specified. The Ministry of Finance is also specified as a user of the proposed interventions.

The PBP presents adequate evidence of internal (but not external) validity for the proposed solutions. The vertical logic is clear and well specified. The Result Matrix is adequately constructed.

The PBP identifies and adequately addresses the monitoring and evaluation requirements. It also proposes an ex post economic analysis to estimate the fiscal financial savings resulting from the intervention. The PBP's overall risk is rated Medium. Mitigation measures were identified with appropriate monitoring indicators.

POLICY MATRIX

Objective	Policy conditions of the first programmatic operation	Triggers for the second programmatic operation
Component I. Macroeconomic stability		
Macroeconomic stability	1.1 Maintenance of an appropriate macroeconomic framework that is consistent with program objectives, as established in the Policy Matrix.	1.1 Maintenance of an appropriate macroeconomic framework that is consistent with program objectives, as established in the Policy Matrix.
Component II. Policy reforms and management of public expenditure and revenue Passage of legal instruments for policy and fiscal management to strengthen fiscal sustainability and efficiency		
Macrofiscal management	2.1 Passage and entry into force of the LRF, which contains the following measures applicable to the NFPS, as a minimum: (i) Fiscal rules that set caps on the primary balance and the public debt; and (ii) Creation of a MLTFF.	2.1 Fulfillment of measures that are consistent with the primary balance targets (≥ 0%) and the NFPS pension debt (≤ 65% of GDP) established in the LRF for the 2019 budget.
	2.2 Publication of the MLTFF (2017-2027), containing aggregate projections for the main fiscal variables as a guide for fiscal policy.	2.2 Publication of the MLTFF (2018-2028).
	2.3 Inclusion of measures for compliance with the LRF in the 2018 budget: (i) Prohibition on creating positions not provided for in the budget, new economic benefits for public employees, and the purchase of extravagant goods and equipment; and (ii) Declaration of budget allocations to finance social programs that benefit women, children, and older adults, family farmers, and other vulnerable and poor population groups as nontransferable.	2.3 Inclusion of measures in the 2019 budget of measures to comply with the LRF: (i) Current expenditure (excluding pensions) should not exceed 18.5% of GDP; and (ii) Declaration of budget allocations to finance social programs that benefit women, children, the disabled, older adults, and other vulnerable and poor groups as nontransferable.
	2.4 Strengthening of processes and internal controls on payroll spending in the Ministries of Education and Health and the National Water and Sanitation Administration through studies on optimizing payrolls, with recommendations to make their management more efficient.	2.4 Strengthening of processes, information tools, and internal controls on payroll spending through: (i) The development of an electronic payroll (computer application) to support operations management and electronic wage payments (SIRH-II) for central government institutions.

Objective	Policy conditions of the first programmatic operation	Triggers for the second programmatic operation
Government procurement management	3.1 Implementation of the electronic procurement portal, COMPRASAL-II, starting with the open tenders module (phase 1) through: (i) Approval and entry into force of measures making it compulsory for all government institutions to gradually migrate to COMPRASAL-II; (i) Approval of operating rules for the COMPRASAL-II open tenders transaction module; and (ii) Training in and implementation of the open tenders module in at least 15 public sector institutions.[1] 3.2 Elimination of the use of brokers for central government institutions in the reverse auctions administered by BOLPROS.	3.1 Implementation of the COMPRASAL-II electronic procurement portal competitive bidding module (phase 2) by: (i) Developing the second government procurement transaction module for competitive bidding in the COMPRASAL-II portal; (ii) Approving the operating rules for procurements using the competitive bidding transaction module in COMPRASAL-II; and (iii) Providing training in and implementing the open tenders transaction module in COMPRASAL-II in at least 30 public sector institutions. 3.2 Preparation and submission to Legislative Assembly of amendments to the LACAP to incorporate efficient and transparent contracting mechanisms, including the compulsory use of electronic reverse auctions, framework agreements, or electronic catalogues.
Results-based budgeting and management of the medium-term expenditure framework	4.1 Replacement of the system of budgeting by management areas with a new results-based budgeting (RBB) system (phase 1): (i) Training for the employees responsible for the budget and planning in 100% of public sector institutions, in accordance with the training and technical assistance plan for reforming the budgeting system; (ii) Development of at least 95% of the budget formulation and execution modules in SAFI-II; (iii) Preparation of pilot plans for a MTIF in at least five institutions[2] as an input for the MTEF; and	4.1 Replacement of the system of budgeting by management areas with a new results-based budgeting (RBB) system (phase 2) through: (i) Approval of RBB in 100% of public sector institutions; (ii) Implementation of the budget formulation and execution modules in SAFI-II; (iii) Approval by 100% of central government institutions of a MTIF which, in future, will serve as input for the MTEF; and

[1] The institutions include at least five of the 13 government ministries.

[2] Ministry of Health, Ministry of Economy, Ministry of Education, Ministry of Public Works, Transportation, Housing, and Urban Development, and the Salvadoran Institute for Comprehensive Child and Adolescent Development.

Objective	Policy conditions of the first programmatic operation	Triggers for the second programmatic operation
	(iv) Approval of a new edition of the Public Sector Financial Transactions Classification Manual, to be used as the basis for formulating and executing RBB.	(iv) Submission to the Legislative Assembly of draft amendments to the Government Financial Administration Act, establishing mechanisms for planning, programming, execution, and evaluation of the new budgeting system, and making the use of SAFI-II, the MTIF, and the MTEF compulsory.
Public investment management and private investment facilitation	5.1 Improvement of the system for public investment management by coordinating investment projects with the new RBB system, including pilot projects with at least four central government institutions, as well as progress in preparing the conceptual and functional model for the public investment system. 5.2 Simplification of administrative procedures for businesses: (i) Publication of the OMR's operations manual to determine the organizational and functional structure of its different areas; and (ii) Signature of plans to simplify procedures (regulatory improvement) for companies in at least five public institutions. 5.3 Implementation of the API[3] through the following measures: (i) Approval and publication of instruments governing the API; and (ii) Signature of at least two agreements with private enterprises.[4]	5.1 Approval of the macroprocess of managing pubic investment, including its conceptual and functional definition. 5.2 Simplification of public sector administrative procedures by: (i) Drafting and submitting an administrative procedures bill to the Legislative Assembly for simplification of procedures, general rules, and use of new technologies in public administration procedures; and (ii) Implementing procedural simplification plans (for regulatory improvement) for enterprises in five public sector institutions. 5.3 Signature of at least two additional agreements with public companies under the API.

[3] The API is a nonreimbursable line of support designed to provide public goods and services to facilitate and supplement private investment. The regulatory tools establish that it functions under a competitive and transparent process to identify, complement, and leverage private investment.

[4] The agreements are: (i) expansion of the aircraft maintenance company AEROMAN; and (ii) technical assistance for dairy product producers and implementation of improvements in productive processes.

Objective	Policy conditions of the first programmatic operation	Triggers for the second programmatic operation
Management of tax collection and tax transparency	6.1 Implementation of a program to strengthen collection management and the Ministry of Finance's tax information and control system, through the following measures: (i) The creation of a DCTA to improve management of collections; (ii) Signature of agreements to integrate databases belonging to public agencies with the Ministry of Finance, including the RNPN, ISSS, and INSAFOCOOP; and (iii) Passage and entry into force of a temporary law to facilitate voluntary compliance with tax and customs obligations. 6.2 Inclusion of El Salvador as a full member of the Global Forum and satisfactory compliance with the standard for the exchange of tax information on request with other member jurisdictions.	6.1 Strengthening the Ministry of Finance's collections management, information system, and tax control by: (i) Starting up the DCTA through the establishment of a risk management system for tax and customs debts; and. (ii) Signing an agreement with the CNR, implementing the agreements reached, and integrating the databases of public agencies (the RNPN, the CNR, the ISSS, and INSAFOCOOP) with the Ministry of Finance's Internal Revenue, Customs, and Treasury Administrations. 6.2 Preparation of a bill on compliance with the Global Forum's ultimate beneficial ownership standard for transparency.
Component III. Pension system reform		
Institutional strengthening of the pension system to attain long-term stability, provide lifetime pensions, and improve intergenerational equity.	7.1 Passage and entry into force of the SAP Act and the FOP Act, which include the following measures as a minimum: (i) A change in the SAP contribution rate from 13% to 15%; a reduction in payments for disability and survivor insurance and in the commission on individual AFP accounts from 2.2% to 1.9% in 2022; and an increase in the interest rate on CIPs from 2.6% to 6%; (ii) Creation of longevity insurance to ensure continuous and permanent income for old-age pensioners and survivors, and creation of a Solidarity Guarantee Account to finance the longevity insurance; (iii) Establishment of a risk committee to determine investment caps for the different types of instruments and minimum risk ratings for the instruments invested in the pension funds, and creation of an actuarial committee to determine minimum pensions amounts, review life expectancy for determining the retirement age, and review the adequacy of the Solidarity Guarantee Account; and	7.1 Regulation of the SAP Act for pensions and regulation of the FOP Act and its implementation, including the following measures as a minimum: (i) Implementation of an increase in the contribution rate from 13% to 15% to remain in effect for at least one year, implementation of the reduction in the cost of disability and survivor insurance and the commission charged on individual AFP accounts from 2.2% to 2%; and issue of CIPs with the interest rate increasing from 2.6% to 6%; (ii) Preparation of regulations governing longevity insurance, including regulation of the Solidarity Guarantee Account to finance that insurance; (iii) Preparation of regulations governing the operations of the risk committee and design of a regulatory framework for the establishment of an actuarial committee to determine minimum pension amounts, review life expectancy to determine retirement ages, and review the adequacy of the Solidarity Guarantee Account; and

Objective	Policy conditions of the first programmatic operation	Triggers for the second programmatic operation
	(iv) Modification of pension benefits through the following measures: (a) cap of US$2,000 on the maximum monthly benefit for SPP pensioners; (b) incorporation of a maximum pension of 55% of the wage into pension-calculation formula for workers who migrated from the SPP to the SAP; and (c) a reduction in disability and survivor pensions from 70% to 50% of the wage.	(iv) Implementation of the changes in pension benefits for SPP pensioners, pensioners who migrated from the SPP to the SAP, and disability and survivor pensioners.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/18

El Salvador. Loan ____/OC-ES to the Republic of El Salvador
Fiscal Strengthening for Inclusive Growth

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of El Salvador, as borrower, for the purpose of granting it a financing to cooperate in the execution of the fiscal strengthening for inclusive growth program. Such financing will be for the amount of up to US$350,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __________ 2018)

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