

**PROGRAM FOR PRODUCTIVE REACTIVATION OF  
MICRO, SMALL, AND MEDIUM BUSINESSES**

**SUMMARY OF FINDINGS AND RECOMMENDATIONS**

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## ANNEXES

- I. Housing Sector
- 11. Alternative Financing Mechanisms
- III. Non-Financial Technical Assistance
- IV. Policy for Investment Promotion

## List of Acronyms

ACDAU	<i>Asociación Consejo Departamental de Alcades de Usulután</i> (Advisory Association for the Mayors of Usulután)
BMI	<i>Banco Multisectorial de Inversiones</i> (Multi-sector Bank for Investments)
CABAI	Central American Bank for Economic Integration
CENTROMYPE	<i>Fundación Promotora de la Competitividad de la Micro y Pequeña Empresa</i> (Foundation to promote the Competitiveness of the Micro and Small Business)
CONAMYPE	<i>Comisión Nacional para la Micro y Pequeña Empresa</i> (National Commission for Micro and Small Enterprise)
FHA	Federal Housing Administration (United States)
FIDEICOMISO	Spanish for Trust, as in a property trust
FIDEMYPE	<i>Fideicomiso para la Micro y Pequeña Empresa</i> (Small and Micro Enterprise Trust)
FONAVIPO	<i>Fondo Nacional para la Vivienda Popular</i> (National Fund for Citizen's Housing)
FORMIR	<i>Fortalecimiento de las Microfinanzas Rurales</i> (Strengthening of Rural Microfinance)
FSV	<i>Fondo Social para la Vivienda</i> (Social Fund for Housing)
FUNDAMICRO	<i>Fundación para la Microempresa</i> (Foundation for the Microenterprise)
FUSADES	<i>Fundación Salvadoreña para el Desarrollo Económico y Social</i> (Salvadoran Foundation for Economic and Social Development)
GOES	Government of El Salvador
IDB	InterAmerican Development Bank
MFIs	Micro-Finance Institutions
MYPEs	<i>Micro y Pequeñas Empresas</i> (Small and Microenterprises)

NGO	Non-governmental Organization
PROESA	Promoting Investment in El Salvador
PROPEMI	<i>Programa para Pequeña y Micro Empresa</i> (Program for Small and Microenterprises)
SME	Small and Microenterprises
TAF	Technical Assistance Fund ( <i>Fondo de Asistencia Técnica para el Desarrollo de la Micro y Pequeña Empresa, Spanish translation</i> )
USAID	United States Agency for International Development
VA	Veterans Administration (United States)
VMHUD	Vice-Ministry of Housing and Urban Development

## Introduction

Early in 2001 severe earthquakes struck parts of El Salvador causing substantial damage in the affected areas. Major efforts are underway on the part of the Government of El Salvador and international donors to rebuild the damaged infrastructure and restart economic activity in the affected areas. Nevertheless these efforts will not be adequate to reactivate local economies throughout the country. As a result, the United States Agency for International Development (USAID) and the Government of El Salvador (GOES) agreed to cooperate in identifying priority needs and actions to reactivate economic activity of small and micro enterprises in the earthquake damaged region as quickly as possible.

To assist in channeling reactivation efforts efficiently, areas of need were reviewed and possible approaches, mechanisms and strategies to address these needs were evaluated. Emphasis was placed on:

1. Expansion of credit for housing and enterprises;
2. Developing means of stimulating economic growth through non-financial technical assistance to small and micro enterprises, and;
3. Identification of policy and program interventions that will contribute to the promotion of foreign direct investment.

Each of these areas of interest was examined to assess the problems and constraints and to identify programs, mechanisms and strategies that could serve to stimulate economic growth and generate more employment. It was recognized that a dynamic and growing economy offers the best opportunity to the country to overcome problems of poverty and social development. The small and micro enterprise sector is especially vulnerable to economic downturns and especially affected by catastrophes such as the earthquakes. This assessment and recommendations are directed to enhancing the well being of this sector.

## **Task 1: Increase financial resources borrowed to reactivate the economy**

### ***1.1. Housing Sector Finance***

The study of El Salvador's housing sector focused on a number of specific topics set forth in the terms of reference for this consultancy. The attached full report (see Annex I) addresses each of these topics in some detail but the key findings are summarized below.

**The InterAmerican Development Bank (IDB)** is in negotiation with the Government of El Salvador for a housing sector loan program. Negotiations began in 1999 but as a result of the earthquakes total program funding has been increased to \$148 million. Of this, \$95 million will be in the form of a loan from the IDB. The proposed program is quite comprehensive but is principally directed at the problems of urban housing for the poor. The three main elements are:

1) assistance to the formal sector through technical assistance to strengthen the mortgage market, institutional strengthening of Fondo Nacional para la Vivienda Popular (FONAVIPO) and development of a non-interest rate subsidy program for the Fondo Social para la Vivienda (FSV).

2) assistance to the informal sector through a squatter settlement improvement program starting with the ten largest municipalities, a housing subsidy reconstruction program for earthquake impacted areas, financial assistance to legitimate and record titles in urban areas as well as a system to improve land title registration in rural areas and improvement of the operations of the Vice Ministry for Housing and Urban Development.

3) assistance to the San Salvador metropolitan area to improve housing in squatter settlements.

Two major issues between the GOES and the IDB with respect to this loan package are the role of FONAVIPO in providing housing loans – the IDB wants it to confine activities to subsidies only, and the interest rate policy of the FSV – the IDB wants loans issued at market rates, not subsidized. Negotiations are expected to conclude before year-end.

**Productive housing** is defined as a housing development or lending program that presupposes the operation of a productive enterprise or business within the house being developed or financed. That microentrepreneurs in El Salvador suffered business losses as well as shelter because of earthquake damage to their houses is well recognized and USAID's earthquake reconstruction programs for housing and replacement of productive assets address this problem to a degree. In most countries, "productive housing" programs are included as part of the microfinance structure, an approach now beginning in El Salvador.

**A housing leasing program** for El Salvador was proposed as a mechanism to enable people without enough money saved for down payments to obtain housing. The proposed program is based on a successful Chilean model. To put such a program into effect in El Salvador will require legislation.

It was presumed that there was a gap between families earning less than two monthly minimum salaries (\$288), who were to benefit from housing grants and those over eight monthly minimum salaries (\$1,152) who could access bank mortgage credit. There would appear to have been no feasibility study or market survey done to validate this assumption. In the event it was found that Salvadoran commercial banks - having excess liquidity and in some cases unsold housing inventories - have developed innovative mortgage programs requiring down payments of as low as 5% with payment terms running as long as 30 years. These programs appear suitable for families at income levels as low as four monthly minimum salaries (\$576). The principal barrier to acquiring housing appears not to be lack of money for down payments but lack of capacity to meet the monthly payments for either a mortgage or lease.

As detailed in the report, El Salvador lacks some of the institutional and legal framework necessary to a successful leasing program. Even if these issues are addressed and housing leasing legislation is passed, in all likelihood it will take several years before housing leasing programs take root. A useful positive impact from the proposed legislation, however, is expected for the land leasing activities now common in El Salvador, especially in the rural areas. Developers buy tracts, improve them to varying degrees, and then enter into lease/purchase agreements for individual lots. The lessees generally begin construction of a house on the lot over time with their own resources, a process that offers a real guarantee of payment to the lessor. When the final lease payment is made, usually in ten years, title to the land transfers to the lessee. Legislation can put into place a legal framework that does not now exist that will spell out obligations and rights for both parties and enable government oversight of the activities of the lot developers.

USAID is assisting the Banco Multisectorial de Inversiones (BMI) in preparing a draft legislative initiative that can serve as the basis for the new law.

**Cooperative housing** represents a specific kind of cooperative that focuses only on providing its members with a housing solution. The housing cooperative is mutually owned and controlled by its membership. Members do not own their housing units, but rather shares or certificates in the overall development that entitle them to the use of the unit in which they live. There are no known housing cooperatives functioning in El Salvador although a number of groups have formed “housing cooperatives” that appear to exist in name only. None has resulted so far in the construction of housing. For housing cooperatives to be successful they need technical assistance to build the needed skills for land acquisition, architectural design, construction of the housing and even the organization and management of the cooperative itself. Specialized institutions to provide this form of technical assistance exist in a number of countries, but none in El Salvador. Without such “technical service organizations” development of successful housing cooperatives will prove difficult.

**Loan Guarantees** in the US and a number of other countries are essentially insurance programs by which mortgage lenders are protected in cases of default on the part of the borrowers. Insurance has costs and these may be borne by the government or through premiums paid by borrowers or a combination of both. Guaranties lessen the risk for lenders and permit lower down payments and underwriting standards, permitting more people to qualify for mortgages, thus expanding the market. US government sponsored loan guarantee programs through the Federal Housing Administration (FHA) and the Veterans Administration (VA) set upper limits on the total mortgage debt that can be guaranteed. Presently the US has private mortgage insurance companies that for premiums paid by the borrower guarantee mortgage repayment to the lending institution for amounts greater than permitted by FHA or VA.

Successful mortgage loan guarantee programs require two things: 1) the ability of the lender to recover the mortgaged asset in case of a default within a reasonable time and, 2) effective underwriting practices that keep the loan default rate to a minimum. In the US recovery of real property in default is not difficult but can place an expensive burden on the lending institutions, which are not usually well prepared to manage real properties. As a result of

political pressure to expand the housing ownership in the US, the housing agencies have in the past several years lowered their underwriting standards. The result has been an increase in mortgage defaults, a process that can be very costly in areas where real estate values have fallen below the loan values of the properties involved. Small or no down payment practices result in the “home owners” having little equity in the property which in turn places the burden of risk on the lender, not the borrower who has little to lose.

In El Salvador, recovery of real property in cases of loan default is difficult and time consuming. There may also be a question as to the experience and capacity of the banking system to underwrite mortgage loans in a manner that minimizes defaults. Any insurance scheme to protect mortgage lenders would imply substantial liability for the government or require premiums paid by the borrowers in the range of one to three percent of the mortgage amount. The actual rate would reflect lenders’ default experience and would add to the cost for the borrower. On balance, under present circumstances a mortgage guarantee program for El Salvador would not seem advisable.

**Housing market coverage** in El Salvador is split between two housing markets; one for the formal sector and another for the informal sector. The formal sector includes people who are employed and have a steady fixed income. Perhaps as many as 800,000 persons are included in this sector and their housing needs are being met by commercial banks. Those in the informal sector rarely have steady sources of income and have difficulty in qualifying for housing credit from not only commercial banks but from microfinance institutions as well, since the latter have not generally entered into medium or long term lending. It is to the informal sector that most government and international donor housing programs have been directed. For those that earn less than two monthly minimum salaries (\$288) access to credit seems out of the question and housing grants the only viable mechanism.

### ***1.2 and 3 Enhanced Credit Instruments***

A separate study (see Annex II) was conducted of microenterprise finance mechanisms directed at housing and at assisting small and micro enterprises in need of having loans restructured or assets replaced because of the earthquakes. The rationale behind the series of proposed new mechanisms and credit instruments was the assumption that poverty can be addressed and economic growth stimulated through expanded credit offerings to small and microenterprises. The GOES proposals had as their intent the duplication of the number of existing microfinance institutions to expand sharply amount of credit available and the utilization of these institutions to provide loan guarantees and debt restructuring programs similar to those introduced on a small scale by USAID as part of the economic recovery effort. Key findings are as follows:

#### **Micro Finance for Housing**

The GOES assigned responsibility for its program to expand the amount of available credit for those who, because of the earthquakes, were in even greater need of resources to rebuild housing and restart their businesses to the Banco Multisectorial de Inversiones (BMI). The

plan was to develop a permanent support structure to assist micro finance institutions, select a group of these institutions to receive funding and training, especially of loan officers, and to stimulate employment and economic growth through increased lending to small and micro enterprises. Earlier BMI had made funding available to supervised financial institutions, i.e. commercial banks, for lending in support of reconstruction and reactivation of the economy. This program was in keeping with BMI's charter of working as a second tier bank supporting the commercial banking sector, but did not provide assistance to non-supervised financial institutions, a category that includes nearly all the institutions that provide credit to micro enterprises.

To enter into the microfinance field, BMI has supported the creation of a Trust that will assume responsibilities for providing financing and supervision to non-supervised micro finance institutions, thus sidestepping its legal inability to fund this class of institution. In organizing FIDEIMYPE, BMI has utilized technical assistance from the Fundación para la Microempresa (FUNDAMICRO) and from the USAID-supported FORMIR-DAI (Fortalecimiento de las Microfinanzas Rurales- Development Alternatives, Inc.) project. Using rather rigorous selection criteria, FIDEIMYPE has picked seven microfinance institutions to participate in the new program. These institutions all have substantial experience in the field and demonstrated portfolio management capacity, with one experienced in housing. These institutions will establish pilot programs focused on providing credit for housing reconstruction or repair for small and microenterprises. Experience gained will be applied in expanding the program..

FIDEIMYPE was expected to receive a limited amount of funding (\$500,000) to initiate the program, funds that were to be made available to the seven institutions designated to participate. Some of the institutions had begun lending under the program, using their own funds.

The goal of assisting those micro enterprises that suffered losses because of the earthquakes in restructuring loans and replacing assets is laudable. But undertaking an expanded program as envisaged places relatively heavy administrative burdens on the financing institutions, burdens beyond what they normally encounter. Restructuring loans and choosing means of subsidizing the replacement of assets lost due to the earthquakes are tasks that require judgment and supervision from qualified financial personnel. For institutions already operating at or near their capacity limit, these added responsibilities pose serious problems. To respond to these extra demands, microfinance institutions will require increased technical assistance and administrative support.

USAID has begun a limited program of replacement of assets, but the program is tied into restructuring existing loans and limited mostly to present customers of the lending institutions that are part of FORMIR. To duplicate or develop a similar program with microenterprises in general requires that the lending institutions have a good understanding of the financial and business backgrounds of the prospective borrowers and the ability to accurately determine their capacity to pay. While there are at least two Salvadoran credit bureaus that provide credit histories on microenterprises, it is not clear how much of the

microenterprise universe is covered and whether the data is used effectively by a majority of Salvadoran microfinance institutions.

It would be ideal if FUNDAMICRO could function as the principal source of administrative, systems and other technical assistance to micro finance institutions. Unfortunately at this time, it lacks both the financial and human resources necessary to perform at the level required.

It would be ill advised to force an expansion of credit for microenterprises beyond the institutional capacity of the microfinance industry. There are, unfortunately, a number of microfinance institutions with weak loan portfolios and that lack the administrative and systems capacity to manage credit effectively. Pushing funds through these institutions runs strong risks of program failure. Limiting credit programs to those few Salvadoran institutions with established records of effective performance may appear to limit overall credit coverage. However, it is much better to work to increase the reach of a few, reasonably large and effective microfinance institutions than to rely on a large number of small, inefficient ones.

In carrying out the BMI program to expand microenterprise credit there should be close coordination with other institutions also involved in assisting microenterprises. In the area of housing, FONAVIPO plays a role and its experience and operations should be accessed. A renewed effort to provide non-financial technical services and replacement of assets lost because of the earthquakes is coming into being in through a newly created Technical Assistance Fund for Micro and Small Enterprise under the direction of THE national Commission for Micro and Small Enterprise (*acronym in Spanish: CONAMYPE*). The interests and activities of the Fund relate directly to issues of credit. Technical assistance to improve business operations may well lead to a need for credit. To obtain credit may require technical assistance in developing a business plan or demonstrating financial feasibility for an operation. Coordination is essential for maximum benefits to small and micro enterprises.

Access to credit for small and microenterprise has long been regarded as a major constraint. This may not be the case. The leading constraint is lack of growth in the Salvadoran economy. Lack of broad economic growth leads to stagnant demand and in the absence of a growing market, microenterprises are not likely to grow either. Confronted by a static market, small and microenterprises must seek innovative ways to find new business, a process for which non-financial services may be better suited.

As mentioned earlier in the report, loan guaranties generally are programs that insure the lender against default, not the borrower. Because of damage to houses and other fixed assets caused by the earthquakes, many of the microentrepreneurs who had borrowed money found their ability to generate income and meet their loan obligations severely impaired. This in turn damaged the portfolio of the lending institutions as in many cases what had been performing loans went into default, raising questions of whether the institutions' loan reserves were adequate. A program undertaken by a USAID-related institution has guaranteed the payment in case of default of a portion of the loan portfolio of those MFI's participating in the FORMIR program. The guaranteed portion of the portfolio does not

require the set aside of reserves, so that the institutions' available reserves can support an existing or even expanded portfolio.

For this kind of guarantee program to be used in the BMI-supported microfinance operation, BMI will have to create or establish within FIDEIMYPE the administrative capacity to evaluate selected institutional loan portfolios for quality and to assume the financial responsibility for payment to them in case of default of any loans included in the guarantee. Again, for this form of guarantee program to be viable, the selection of participating institutions and rating the quality of their portfolios is essential.

## **Task 2: Stimulate the growth of businesses through non-credit instruments.**

In carrying out this task, a review was made of the data gathered by the National Commission for Micro and Small Enterprise (CONAYMYPE) with respect to the composition of this sector of the Salvadoran economy and of the results of a number of surveys carried out of microenterprises. In addition to composition and constraints affecting the sector, the importance of non-financial technical assistance as a force to reactivate economic activity was explored.

### **2.1 Non-Credit Constraints to SME Growth**

#### **Constraints\***

Probably the primary constraint impeding growth of small and micro enterprises is simply the lack of economic growth for the country as a whole. In an environment of a stagnant or slowly growing economy, opportunities to form linkages with larger producers or to expand sales to consumers are sharply limited. If a rising tide lifts all boats, a stationary one lifts none.

Access to finance is not rated by microenterprises themselves as their major constraint. Over half of microenterprises surveyed report their major constraint as "lack of customers". Other constraints widely reported include "excessive competition", low profits and lack of economic resources. Small businesses in the manufacturing sector complain of antiquated machinery and the lack of skilled labor.

These wide spread complaints of lack of customers, low profits, excessive competition are symptomatic of a stagnant market. Too many microenterprises offer the same undifferentiated products or services to an already saturated market.

Another constraint affecting microenterprise development is the generally low level of human resource development. Education levels remain low, especially in rural areas, and few possess technical or professional skills. There are also cultural constraints in that many

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\* See Annex III: Part One for a detailed look at the constraints affecting small and microenterprises.

microenterprises operate passively, hoping that someone – government or an NGO – will make life better for them. Working together effectively in groups or associations also is not common as is a generally casual attitude towards contractual commitments.

Since most microenterprises and many small businesses operate in the informal sector, the relatively high costs of registration of the business and of meeting tax, labor and environmental code requirements are avoided essentially by ignoring them.

Breaking out of this situation, for example, by selling to San Salvador or abroad, requires knowledge of and access to the markets to be served and improved business and production skills. New considerations such as quality control, cost control, procurement of materials, supervision of labor, packaging and distribution arise. The first part of the equation is to identify a demand for a product or service. The second part is developing the skills and resources to serve that demand.

Efforts to stimulate economic growth and employment generation through small and microenterprises is not a question of removing constraints but of an understanding of the nature of the microenterprise universe.

CONAMYPE cites the figure of 504,000 as the number of small and micro enterprises active in El Salvador. Some 73% are classified as subsistence microenterprises. Another 16 % are judged to be subsistence but with some potential for growth. The remaining 11% are classified as microenterprises with some savings, microenterprises with significant savings and small businesses. CONAMYPE counts only 5,000 small businesses in the country and another 8,000 microenterprises in the “acumulación amplia” category.

At the subsistence level the typical microenterprise is located in an urban area and headed by a woman (over 70%). As one moves up the scale the prevalence of male participation increases, with 54% of the larger microenterprises headed by men. Nearly 75% of all microeconomic activity consists of very small-scale merchandizing, food service or provision of lodging. Only about 12% are involved in manufacturing.

CONAMYPE calculated that about 43,000 microenterprises were adversely affected by the 2001 earthquakes. The four departments with the greatest number of those affected were: Usulután – 7,650; La Paz – 6,861; Cuscatlán – 4,962 and; San Vicente – 4,641. Of this more than 20,000, at least 90% operate at the subsistence level or just above.

Small and microenterprises that could benefit from non-financial technical assistance are thought by CONAMYPE to represent at most ten per cent of the 500,000 Salvadoran microentrepreneurs and small business people. This is consistent with the experience of CENTROMYPE (*Fundación Promotora de la Competitividad de la Micro y Pequeña Empresa*), which on the national level is working with a universe of only 400 businesses in its efforts to develop exports. However, it is these enterprises that are the most likely to employ other than family members and that offer the best opportunities for business expansion and employment generation.

From the above it is clear that there exists an anomaly in economic policy directed to the microenterprise sector. Policy objectives for microenterprise development programs usually include stimulating economic growth, generation of employment and the eventual “graduation” of microentrepreneurs into the formal economy. The portion of the microenterprise universe that can effectively utilize such support is about ten percent. Resources dedicated to promoting SME economic growth and job creation will either not be used or will be wasted by the 90% of the microentrepreneurs who lack the resources or skills needed. It is this 90% that is the crux of the issue of poverty. For them the issue is not economic growth but social welfare: their need is for measures to alleviate their poverty. Poverty alleviation programs employ a different set of interventions than those designed to stimulate growth - credit programs are of little use for those lacking sufficient income to repay – and their design should recognize that job creation and enterprise development are not likely outcomes.

## ***2.2 Identification of opportunities for growth resulting from reconstruction***

A number of areas have been identified that with appropriate support, offer business opportunities to small and micro enterprises.\*

The earthquakes had major impact in the affected zones on already inadequate infrastructure. Technical assistance and some funding could result in the formation of groups or small enterprises capable of addressing problems in water supply, sanitation, storm water drainage and solid waste collection and disposal. The mechanism would be one in which public funding for infrastructure development would be channeled through local small and micro enterprises, generating employment but more importantly improving the quality of life in the areas concerned.

A second class of opportunity relates to agricultural diversification and expansion. Development of small and micro enterprises with the capacity to install irrigation systems in their localities and to supply technical services to farmers could increase local agricultural production on a sustainable basis.

A third is the provision of services related to housing construction. Technical assistance and training could equip small and micro enterprises to participate in housing programs by entering into housing construction or in providing services of repair, remodeling and improvement from a local base. The value added locally from provision of skilled services would be considerably higher than the income generated solely through employment of unskilled laborers.

A fourth is in the area of health services. Rural areas could benefit not just from assistance from highly trained health professionals or access to hospitals, but from assistance provided at the level of skills needed to advise families on matters of hygiene, nutrition and basic care of illnesses. It is estimated that 36% of rural families in El Salvador lack access to health care. Public or donor assistance could be supplied to these underserved rural populations by

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\* See Annex III: Part Two for supplemental discussion.

health oriented small or micro enterprises trained through technical assistance programs to interact with the local population to improve standards of health.

A fifth opportunity is in the area of tourism. Successful tourism opportunities do require a road network and certain levels of infrastructure. But as employment opportunities for rural areas they also require staff and service providers trained and motivated to operate at acceptable international standards for goods and services. Even roadside cafes can expand business and generate jobs using trained staff and better amenities.

A general opportunity for economic growth and employment generation could result from provision of much better information to small and micro enterprises. Information on markets, pricing and product characteristics would permit business owners to assess their requirements and seek appropriate help to enable them to exploit identified opportunities. Economic reactivation through these mechanisms serves not only to restore the pre-earthquake status but also to move beyond to a new and sustainable level of business.

**2.3 Program Costs & Gross Receipts (PCGR) Analysis Ratios: Replacement of productive assets.**

An economic impact analysis was performed assuming a matching grant of \$1,000,000 (see Annex III: Part III). Using a series of assumptions as to imputed and receipts, an estimated

**TABLE 1: ESTIMATED ECONOMIC IMPACT (US\$)**  
*Matching Grants Programs*

<b>I</b>	<b>BENEFITTED ENTERPRISES</b>	<b>TOTAL</b>
	Total	<b>2,000</b>
	-Subsistence micro firms	1,910
	-Growth micro firms	74
	-Small firms	16
<b>II</b>	<b>EMPLOYMENT, SALARIES AND PROFITS GAINS</b>	
	-Employment	3,524
	-Annual Salaries	\$6,089,472
	-Annual Profits	\$4,693,182
<b>III</b>	<b>ANNUAL FISCAL GAIN</b>	
	-Total Fiscal Income Gain	<b>\$720,313</b>
	-VAT Gain From Salaries	\$379,983
	-VAT Gain From Profits	\$322,140
	-Income Tax Gain From Profits	\$18,190
<b>IV</b>	<b>ECONOMIC IMPACT</b>	
	-Annual Gross Receipts Gain by the Economy	<b>\$10,782,654</b>

short-term PCGR ratio of 9.8 was realized. In other words, an investment of \$1,000 in replacement of productive assets could be expected to result in Gross Receipts to society of over \$9,800. The estimates are for a single one-year period.

Table 2 is a brief description of costs and benefits, which should be considered when calculating the value of the Program beyond the immediate (one-year) emergency costs and benefits, described above.

**TABLE 2: SUMMARY OF SHORT-TERM PROGRAM COSTS AND GROSS RECEIPTS**

<b>I</b>	<b>Social Costs</b>	<b>Lower Estimate</b>	<b>Upper Estimate</b>
	Matching grant	\$1,000,000	\$1,000,000
	Program Operating Costs	\$114,285	\$236,421
	Public Assistance	PA	PA
<b>II</b>	<b>Total Social Costs</b>	<b>\$1,114,285</b>	<b>\$1,236,421</b>
<b>III</b>	<b>Social Benefits:</b>		
	Grant multiplier	\$307,750	\$307,750
	Income Gain	\$10,782,654	\$10,782,654
	Mental Health	MH	MH
<b>IV</b>	<b>Total Social Benefits:</b>	<b>\$11,090,404</b>	<b>\$11,090,404</b>
<b>V</b>	<b>Net Social Benefits:</b>	\$9,976,119	\$9,853,983
<b>VI</b>	<b>Net Lower Estimate Social Benefits Minus Upper Estimate Social Costs</b>	<b>\$9,853,983</b>	

### **Task 3. Identify Priority Approaches for Investment Promotion and Joint Ventures with Foreign and Local Partners**

This task objective was to provide policy and program advice to the GOES with respect to its interest in promoting investment and joint ventures between foreign and local businesses.

***Draft a strategy to promote foreign and local investment.***

Meetings with the director and senior staff members of Promoting Investment in El Salvador (PROESA) combined with a review of current conditions in the economy of El Salvador resulted in a strategy paper setting forth considerations, constraints and priorities for foreign investment promotion for the country.\*

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\* See Annex IV for additional details.

Key points made in the commentary for PROESA is given current circumstances and limited resources PROESA's activities must be focused carefully on those activities and geographic areas that offer the highest potential for growth.

Constraints noted include:

- The problem of El Salvador's image abroad, which remains that of a small country, ravaged by war and still affected by violence. The image is inaccurate but surveys of Salvadoran businesses, including microenterprises, still rank crime and violence at the top of a list of their concerns.
- El Salvador relative to its neighboring country competitors is a high cost source of labor. Cost considerations are important in low skilled assembly industries like apparel and the higher costs in El Salvador are a constraint in attracting certain classes of investor.
- El Salvador's domestic market is small. Few if any investors can be expected to establish manufacturing facilities to serve only the local market.
- Deficiencies in infrastructure and relatively high transport costs also constrain manufacturing. Privatization and improvement in electricity supply and telecommunications services should serve as a positive balance in the infrastructure equation in the near future.
- Investment in El Salvador is constrained by limited natural resources. There are virtually no minerals suitable for exploitation and agricultural production volumes in specific crops are generally below the level that would attract industrial processors.
- Finally, there is the constraint of timing. As the global economy turns downward, willingness of foreign investors to add new facilities falls drastically. This is especially true for apparel, computers and accessories and telecommunications equipment and services.

For investment promotion strategy development a number of priorities were suggested. These were ranked as follows:

- Knowledge industries, like computer programming, call centers, data entry and "back office" operations.
- Services
  - Tourism: eco-tourism, tourism for Salvadoran visitors and regional tourism.
  - Development of "assisted living" centers or similar retirement homes marketed to the Salvadoran expatriate community as a means of caring for elderly family members at costs much lower than prevalent in the US.
  - Air freight and parcel distribution based on facilities developed to exploit the capacity for expansion of the San Salvador International Airport
- Image building, but on a targeted, medium term basis. Mechanisms include developing closer ties with the Salvadoran emigrant communities to explore investment interest and developing ties within specific industry groupings abroad to build awareness of and interest in opportunities offered by El Salvador.

- A shift in strategy for promotion of off-shore assembly industries from a passive one in which the foreign investor is expected to provide the entire enterprise to an active one in which Salvadoran entrepreneurs market in the US and elsewhere their capacity to engage in contract manufacturing or shelter services virtually on a turnkey basis.

## **Task 4: Priority policy and program interventions for the GOES to reactivate the economy**

### ***Recommendations for the Ministry of Economy***

Included in the detailed reports (included as annexes) are a number of recommendations for the Government of El Salvador directed at the reactivation of the economy particularly for the small and micro enterprise. Summaries of the recommendations by section appear below:

#### **Housing Sector**

**Home Improvement** This recommendation is to develop a mechanism to provide financing to land developers who in turn would be able to offer loans to their clients to permit improvement of existing houses or the start of new ones on leased lots. The larger land developers offer or plan to offer loans to leaseholders for housing construction. Their capital is limited and the recommendation is that these developers be permitted to securitize quantities of “seasoned” lease contracts that could be used as collateral in seeking additional financing from commercial banks or other investors, thus expanding funds available for construction loans.

**Home Repair** This recommendation is to support institutional lending to small and microentrepreneurs for replacement and repair of productive housing. Along with the loans would come technical assistance in home repair and business infrastructure improvement and expansion. One NGO has submitted a proposal along these lines.

**Cooperative Housing** To further the development of cooperative housing in El Salvador a technical services organization is needed. This recommendation is that an institution already involved in housing programs be provided the technical assistance necessary to develop this capacity. It is suggested that it would be better to strengthen an existing institution to provide this service than to try to create a new one.

**Loan Guarantees** If El Salvador is to pursue loan guarantee programs, it is recommended that current laws governing property foreclosures and removal of tenants be reformed to allow expeditious completion of the process.

## Enhanced Credit Instruments

**Loan Guarantees** Given the potential value of loan guarantees to microfinance institutions, the GOES should undertake a feasibility study of such programs.

**Technical Assistance to MFIs** To reach a greater number of SMEs, microfinance institutions will need significant technical assistance as well as access to additional funding. Short-term economic reactivation programs should be reviewed as possible sources for additional funding. For technical assistance to MFIs, it is recommended that FUNDAMICRO be restructured and strengthened to give El Salvador a national resource for such support. The GOES should also encourage continued support from international donors and NGOs for programs intended to strengthen MFIs and microenterprise credit in general. Efforts with the MFIs should also be coordinated with other institutions, like FONAVIPO, and donors active in housing and infrastructure.

**Non-financial Services** Efforts should be made to provide non-financial technical assistance to SMEs in a bid: one, to strengthen their business operations and thus their capacity to use financing effectively and, two, to develop accounting and administrative capacity needed to apply successfully for credit.

**Restructuring Debt** Support should be given to the proposed Matching Grants program designed by the newly created Technical Assistance Fund (TAF) as a mechanism to promote both financially and technically the restructuring of debt and replacement of assets on the part of SMEs who suffered losses as a result of the earthquakes.

## Stimulating Growth Through Non-Financial Technical Assistance

### Policy Clarification

The government of El Salvador and the International donor community should clarify their approach to the microenterprise community. For efforts to promote economic growth and generation of employment, assistance efforts have increasingly been directed to small businesses and that small element of the microenterprise sector that has accumulated sufficient assets and experience to serve as a base for further growth. It may well be that for these objectives there is no other practical approach. However, this leaves 90 - 95% of El Salvador's microenterprises without assistance. For this vast majority of microentrepreneurs, most of whom are owner-operators of businesses with incomes barely at the subsistence level, there must be recognition that other types of program assistance in nutrition, health services, education and assistance in improving skills are required if there is to be substantial poverty alleviation. Program development then must recognize the two populations and address the distinct needs of each group.

## Enterprise Development Services

For effective growth and development in the small and microenterprise sector, the entrepreneurs need to improve sharply their capacity to manage, produce and market their goods and services. It is recommended that Government and donor efforts to promote availability of these services take into account such factors as:

- the need to avoid duplicate and haphazard development of the supply of these services and build efficiently on the established infrastructure. This requires organization of an efficient institutional structure for the coordination, management and supervision of these activities.
- the need to determine effective and balanced pricing of these services to reach an optimum balance between the need for cost recovery of the services provided and the capacity to pay of the beneficiaries.
- the desirability of decentralizing the management and development of these programs to empower local municipalities, furthered by greater transparency and competition between municipalities so that all may benefit from successful experiences and lessons learned.
- the recognition that the primary end result of providing technical assistance is to reduce transaction costs whether through better available information or transfer of technology thus permitting beneficiaries to expand sales and improve profit margins.

## Foreign And Local Investment Promotion

### Strategy

Priorities for investment strategy are listed above. The basic recommendation for PROESA is that it takes the opportunity now in a period of slowing economic activity to build for the future. Mechanisms include development of sustainable relationships with overseas Salvadoran emigrants and with foreign industrial or service groups that offer the possibility of investment when the global economy resumes growing. In addition, PROESA should encourage proactive efforts on the part of Salvadoran entrepreneurs of whatever size to seek business from abroad. Meeting the demands for such business opportunities as may be identified meets the primary requirement for investment promotion, that it be demand driven.

## Task 5: Priority Recommendations for Private Enterprises to Reactivate the Economy in Four Regions of the Country.

In the course of the reviews undertaken of the current situation of small and micro enterprises in El Salvador, emphasis was placed on identifying possible measures that would assist in the reactivation of the economy in those areas most badly damaged by the earthquakes. International donor assistance in rebuilding houses and restoring infrastructure at best restores the situation to about where it was before the earthquakes but does not address

problems of poverty and weak economic growth in existence before the earthquakes and made worse by their impact.

Keeping in mind that USAID's presently available resources are limited, it is recommended that assistance be channeled for the provision of non-financial technical assistance to small and micro enterprises in one or more of the four Salvadoran Departments most affected, Usulután, San Vicente, La Paz and Cuscatlán.

Two institutions have been identified that would be appropriate vehicles for programs of this nature. These institutions are: *Fondo de Asistencia Técnica para el Desarrollo de la Micro y Pequeña Empresa* (TAF) and CENTROMYPE.

TAF has just been established and is in its organizational stage. Its objective is to establish a network of institutions that in turn will provide non-financial enterprise development services to SME's but on a new footing, one that will be demand driven. At present the implementation agency for TAF is El Salvador's National Commission for Micro and Small Enterprises (CONAMYPE). Two CONAMYPE staff employees have been assigned to TAF and will be supported by CONAMYPE management in the further development of the institution.

The design of The Fondo de Asistencia Técnica calls for a three-tiered structure. At the top, the third tier, is the Fund's secretariat and managing board. Their functions will be to:

- provide funding.
- establish the regulatory framework for the program.
- provide overall program supervision.
- monitor and evaluate the programs' impact.
- serve as a source of information and promotion for the program.

The second tier is to be made up of private operating agencies that will operate as the public face of the program, administer the service and other subsidies envisaged in the program and most importantly serve as the link between the enterprises seeking assistance and the service providers. They will also be charged with monitoring the quality of the technical services provided the program's clients.

The first tier is the operational one: consultants, firms and other institutions providing technical assistance on a for fee basis in response to demand from small and micro enterprises.

TAF's target clientele are defined as enterprises whose sales do not exceed six million colones (\$686,000) nor employ more than 50 people. The users of the technical services will thus be small businesses and the larger and more ambitious of the microentrepreneurs. CONAMYPE estimates that the potential target clientele represents about 10 % of the overall estimated microenterprise population.

### *Organizational Chart - TAF*

## **Fondo De Asistencia Técnica para la Pequeña y Micro Empresa**

### **Structure**

#### **Third Tier (Tercer Piso)** TAF central management.

Responsibilities to set policy, establish regulations, manage program with special reference to supervision, distribution of funds, monitoring and evaluation

#### **Second Tier (Segundo Piso)** Private Operating Agencies (Ventanillas)

Selected private sector institutions (NGOs, Associations) that serve to link demand from Micro and Small Enterprises (MYPES) to pros of technical assistance. Responsible for selecting areas of interest and responding to requests for assistance. Decide whether applicant qualifies for program participation and on what terms. Administer matching grants from funds provided by TAF or directly from other sources..

#### **First Tier (Primer Piso)** Technical Service Providers

These are individuals, companies, institutions that provide non-financial technical services to qualified MYPES on a for-fee basis. Their availability and range of services are made known to prospective clients by the Private Operating Agencies, but the choice of service provider is left to the recipient. Reimbursement of fees will be through the Private Operating Agency, which will assure that the client's share of the matching grant is in hand before the services are provided and that the agreed services have been supplied prior to payment of the total grant amount.

For purposes of administrative efficiency, an initial program intervention could take the form of a cooperative agreement with TAF. The agreement would have as its objective the provision of funds for the matching grant programs to be administered by the private operating agencies and would serve to subsidize these services for qualified small and microenterprises. The Agreement could include conditions that would specify which of the several private operating agencies that have indicated an interest to participate would be beneficiaries of USAID funding and it would also set geographic limitations in accordance with the terms of the Special Objective for Earthquake Recovery and Reactivation.

An alternative form of program intervention may be preferable in view of TAF's very recent formation and lack of experience in administering the proposed program. Administrative support can be expected from CONAMYPE, but its staff resources are also limited. The alternative would be to enter into cooperative agreements with perhaps two institutions that are prepared to function as private operating agencies in the areas of concern. Two which have expressed willingness to enter into such agreements are the Asociación Consejo Departamental de Alcades de Usulután (ACDAU) and the Programa para Pequeña y Micro Empresa (PROPEMI), the division of the Fundación Salvadoreña para el Desarrollo Económico y Social (FUSADES) that works with small and micro enterprise.

ACDAU is relatively recent, but represents an interesting and outstanding local effort to organize to meet challenges of development. ACDAU has worked with USAID and the Spanish assistance agency to carry out programs of infrastructure and rural roads. It has the presence, knowledge and interest in its geographic area, which now includes around 20 municipalities within the Department. The area lies more in the northern hills region of the Department and does not include the coastal areas.

USAID/El Salvador has had a long-standing relationship with FUSADES including previous programs undertaken in conjunction with PROPEMI. This division is currently carrying out a number of programs involving small and micro enterprise development. It has a client base in San Vicente and would be prepared to work in the Departments of La Paz and Cuscatlán from its central headquarters in San Salvador.

Program intervention will take the form initially of the one or more cooperative agreements as described above. With additional funding expected to be available in FY 2002, program intervention may be expanded. Expansion, however, will be contingent on actual program experience in providing technical assistance. The characteristics of this program, in that it is to be demand driven, have not been tested in El Salvador and there will need to be evidence that the program's premises are sound and that small and microenterprises are in fact willing to participate in cost sharing arrangements to secure assistance. Private operating agency activities then will be "pilot projects" and while there may only be preliminary results available at the time the decision is made for added funding, these early results may indicate whether the program will work.

The second phase of program intervention to supply non-financial technical assistance to small and micro enterprises could include a cooperative agreement with CENTROMYPE. This organization was recently established with a small grant from the Central American Bank for Economic Integration (CABEI) and administrative support from the *Banco Multisectorial de Inversiones* (BMI).

It is focused on providing marketing services and related technical support to assist small and microenterprises to export. It has identified some 400 companies that have both the interest and capacity to make the changes in operations, product appearance and quality necessary to export successfully. It is now in its second year of operation and has demonstrated the capacity to generate overseas sales by a growing number of Salvadoran small businesses virtually all of whom are new to export. It has a permanent staff of 7 and contracts services

from another 30 people who staff the call center and provide technical support to clients. The call center serves as source of information on overseas markets and requirements to prospective clients who telephone the center.

Other elements for an expanded program should include additional funding to TAF. If the initial phase comprised cooperative agreements with private operating agencies like ACDAU or PROPEMI, then consideration should be given to replacing in effect these agreements with a single cooperative agreement with TAF. By the time of the second phase program intervention, TAF should have demonstrated sufficient institutional development and operating experience to qualify for such an agreement. The advantage would be to simply project administration and permit funding for a larger number of private operating agencies.

A final element that may be advisable would be the provision of short term and highly specialized non-financial technical services from an American contractor.