Understanding Challenges for More and Better Jobs in El Salvador: An Integrated Approach
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ABBREVIATIONS AND ACRONYMS

ACS .................. American Community Survey
ALMPs ............... Active Labor Market Programs
CCG .................. Caisse Centrale de Garantie
CCT .................. Conditional Cash Transfer
CEPR ................. Center for Economic and Policy Research
CGS .................. Credit Guarantee Scheme
COFEMER ............ Federal Commission for Improving Regulation
CONAMYPE ........ La Comisión Nacional de la Micro y Pequeña Empresa
CPI .................. Consumer Price Index
CVQ .................. Caribbean Vocation Qualification
DIGESTYC ......... Dirección Nacional de Estadística y Censos
EHPM ................. Encuesta de Hogares de Propósitos Múltiples
G2P .................. Government-to-Person
GDP .................. Gross Domestic Product
HCI .................. Human Capital Index
ICT .................. Information and Communications Technology
IFC .................. International Finance Corporation
ILO .................. International Labour Organization
INSAFORP .......... Instituto Salvadoreño de Formacion Profesional
ISSS .................. Salvadoran Institute of Social Insurance
LMIS ................. Learning Management Information System
LMO .................. Labor Market Observatory
MCC .................. Millennium Challenge Corporation
MINEDUCYT ....... Ministry of Education, Science and Technology
MSEs .................. Micro and Small Enterprises
MSMEs ............... Micro, Small, and Medium Enterprises
MTPS ................. Ministry of Labor and Social Welfare
NEETs ............... Not in Education, Employment, or Training
NOAA ............... National Oceanic and Atmospheric Administration
NQF .................. National Qualification Framework
OECD ................. Organisation for Economic Co-operation and Development
OMR .................. Institute of Regulatory Improvement
OSS .................. One-stop-shop
REER ................. Real Effective Exchange Rate
SEDLAC ............. Socio-Economic Database for Latin America and the Caribbean
STEP .................. Skills Towards Employment and Productivity
TVET ................. Technical and Vocational Education and Training
USAID .............. United States Agency for International Development
UNESCO .......... United Nations Educational, Scientific and Cultural Organization
UNFPA ............ United Nations Population Fund
VET ................ Vocational and Professional Training
VSE ................ Very Small Enterprise
WAP ............... Working Age Population
WBES .............. World Bank Enterprise Survey
WDI ............... World Development Indicators
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Women selecting coffee beans at a roasting facility
EXECUTIVE SUMMARY

An influential article written 15 years ago argued that the Salvadoran economy was a puzzle. The country had implemented market-friendly reforms since the 1980s and did not face constraints in skills and capital; yet, economic growth was nowhere to be found (Hausmann and Rodrik 2007). The report claimed that two out of the three key factors that foster economic growth existed in El Salvador. First, there was an appropriate supply of skills, as shown by the relatively low returns to education, particularly for high school education. The economy also had a proper level of savings, as suggested by the investment-grade credit ratings and by the low current account deficit. Second, the expected appropriability of investments was high, since taxation was moderate, the macroeconomic fundamentals were stable, and concerns about contract enforcement and property rights were unwarranted. The report concluded that the missing piece of the equation was the lack of innovation, in terms of the ability to identify and operate activities in new sectors.

By 2019, it would be naive to claim that the puzzle still exists. El Salvador has one of the highest rates of crime and violence in the world, though since June 2019, there has been substantial reduction in crime and violence rates as a result of key actions implemented by the current government's administration. Regardless of the level of government taxes, the expected costs of crime as well as the large expenditures that firms must incur for prevention represent a dramatic tax to the private sector—without any expected benefits. Laws and regulations did not adapt to a changing world and exacerbated the segmentation in the labor market, making it difficult for firms to enter, survive, and create jobs in the formal sector. Without appropriability and innovation, it is not surprising that labor productivity has been stagnant, the quality of jobs is low and worsening, and the inclusion of vulnerable groups has not improved.

This report provides a detailed analysis of the Salvadoran labor market between 2000 and 2017 and identifies the main bottlenecks preventing the creation of more and better jobs. It does so in three blocks. First, it describes the main trends in economic growth, its drivers, and implications for job creation. Second, it provides an in-depth analysis of factors constraining the demand for labor. Third, it analyzes which are the skills that the private sector is demanding, and what are the factors contributing to the wide and persistent gender and youth gaps in the labor market.

This report was prepared before the COVID-19 crisis hit the region. While it is still too soon to assess the effects of the COVID-19 outbreak on jobs, incomes, and welfare, early estimates suggest that the impacts on economic activity are already significant in the Latin American and the Caribbean region (World Bank 2020). The uniqueness and scale of this crisis imply that its analysis—as well as the specific policy responses—is beyond the scope of this report. However, the policy implications chapter dedicates a special section on policy responses that other countries are implementing to confront the crisis. More importantly, the structural reforms outlined in this jobs diagnostic to create more and better jobs will continue to be relevant and will play an important role in the recovery process after the COVID-19 emergency. This is particularly important in a country like El Salvador, where even before this crisis, many families did not have access to jobs that would provide them with social security coverage or with the capacity to save for bad times.

1 The low returns to high school education in El Salvador have been documented by Aedo and Walker (2012). They suggest a lack of better jobs for middle-skill workers.
THE BIG PICTURE: THE JOBS CHALLENGE IN EL SALVADOR

Fewer than two out of every three Salvadorans are employed. About 70 percent of workers are informal\(^2\)—that is they are not covered against important risks—and average real wages are lower than in 2004. To raise the employment rate to 80 percent of the population by 2030, 1.4 million jobs will have to be created. A back-of-the-envelope calculation suggests that the yearly rate of job creation and gross domestic product (GDP) growth would need to be at least 3.3 percent and 3.9 percent, respectively, for the next 10 years. This is an ambitious goal considering that those figures have been on average 0.8 percent and 2.2 percent, respectively, since 2005. Moreover, while economic growth may be a necessary condition for job creation, it is certainly not a sufficient one. Since men already have employment rates of about 80 percent, most of the jobs that would need to be created are for women, a fact that reveals the existence of structural barriers faced by this group that go beyond the meager economic growth levels. In addition, economic growth will not necessarily improve the quality of jobs. In fact, it is more linked with job creation in the informal services sector, than with the creation of formal jobs.

A DORMANT PRIVATE SECTOR

The scarcity of good jobs is largely driven by a static private sector, where the rate of entry of new formal firms is among the lowest in the world and where businesses fail to grow. Even when compared to other countries in the region, medium-size firms account for a very small share of employment in El Salvador. Jobs are mostly concentrated in very small firms, followed by large ones. This is another symptom of the segmented nature of the labor market: most jobs are in small unproductive firms, which do not have the incentives or the capacity to be formal and stay informal in the long term, or in large productive firms, which have the capacity but also do not have another choice but to be formal given their higher visibility.

Visibility is not an attractive trait for firms in El Salvador. Larger firms are more likely to be targeted by criminal organizations and by government inspections than their smaller counterparts. Older and formal firms are also more likely to be crime victims than younger and informal ones. This weakens the incentives to grow and become formal. For those firms that are already large, the cost of crime and violence constitutes a tax on their profitability making them less competitive in comparison with their global peers. Evidence from a natural experiment shows that a 27 percent decline in homicide rates in El Salvador during the 2012 truce increased formal employment in micro and small firms by 5 percent and 3 percent, respectively. The impacts on salaries were larger, as micro and small firms increased their wage bill by 9 percent and 6 percent, respectively. Large firms were not significantly affected.

Formalization is not a feasible option for most firms. Among small businesses, the costs of complying with registration, taxes, and social contributions are prohibitive. For those at the bottom 40 percent of revenues, these costs represent at least 68 percent of their annual sales. More importantly, the benefits are not clear either when basic services such as public safety are not effective.

But even if crime and violence decreased, firms would still face important barriers in El Salvador. The process to obtain permits and licenses is lengthy and expensive. Some companies claim that this is explained by a lack of knowledge of the operability requirements of the sectors by the government, absence of qualified technical staff at public sector entities, and high levels of bureaucracy. Formal firms also claim that unfair competition from informal businesses is a barrier to growth. This is part of a vicious cycle that is difficult to break, as informal businesses provide most of the jobs but still pose a negative externality to firms that are the most productive.

Changes in the allocation of labor that are associated with processes of structural transformation do not exist in El Salvador. Higher-productivity sectors in El Salvador such as finance, transport, and information and communication technology (ICT) remain small. The sectors that experienced the largest gains in employment shares since 2005 are hotels and restaurants, domestic services, and agriculture. All three are among the least

\(^2\) Encuesta de Hogares de Propósitos Múltiples (EHPM) 2017, Dirección Nacional de Estadística y Censos (DIGESTYC).
productive sectors in the economy. Among the higher-productivity sectors, those that expanded the most are those with higher informality levels. In any case, low levels of productivity across all sectors seem to be a more important issue in El Salvador.

**Despite the gains associated with ICT, most small firms remain unconnected in El Salvador.** Small firms that use ICT in El Salvador are 20–30 percent more productive and 9–18 percentage points more likely to be formal, and they also pay higher wages than their counterparts that have not adopted the technology. Among firms with 50 employees or less, 80 percent did not use any internet connection during the past year. This lack of connectivity is reflected in the overall internet penetration among people: El Salvador ranks very low not only in Latin America but also among countries at the same level of development. Surprisingly, the cost of internet access is comparable to that of other countries in the region.

**LABOR IS ABUNDANT, BUT JOBS ARE SCARCE**

The returns to a college degree have declined even further in El Salvador. This is one area where the conclusions of Hausmann and Rodrik (2007) still hold. The supply of college graduates has increased, but the demand for their skills did not keep up, as suggested by the declining skill premia. While, in 2007, a male college graduate earned wages 75 percent higher than those who only completed primary education, by 2017, that premium declined to about 36 percent. In fact, college graduates are the only skill group that experienced a decline in real wages since 2010.

Migration patterns are also consistent with the claim that the falling wage premium attached to a diploma is falling in El Salvador. Adult Salvadoran migrants in the United States (including recent ones) are 20 percentage points more likely to have a high school diploma than their counterparts at home and are 1 percent more likely to have a college degree. Moreover, Salvadoran migrants in the United States are more likely to be employed in industries more intensive in skills than those left behind, who are 17 percentage points more likely to work in agriculture. In other words, the Salvadoran labor force is experiencing the structural shifts associated with economic development—just not at home.

But diplomas do not always equate with skills and the educational system may be failing to keep up with the skills required by the private sector. Certain personal traits are difficult to measure and cannot be cast on a diploma. The skills of the future—that is, those that benefit from new technologies—such as being able to work in groups, to supervise, and to provide solutions, among others, are often in high demand by employers but are not easily observable. In contrast to more dynamic economies, the share of occupations intensive in the skills of the future is shrinking in El Salvador. On the other hand, the share of occupations intensive in routine skills that are more susceptible to be replaced by new technologies is increasing. Surprisingly, young workers are more likely to be employed in the jobs of the past than in the jobs of the future than their older peers.

Remittances may also help explain the poor integration of women into the labor force. Evidence shows that women living in households that receive remittances are 13 percentage points less likely to look for a job (Sousa and García-Suaza 2018). This link is particularly stronger among unskilled women.

The poor and declining quality of jobs reflects low labor productivity in the private sector. Registered firms in the top productivity quintile pay average wages eight times higher than their peers in the lowest quintile. This link also exists—but is weaker—among unregistered firms. Among a sample of firms with 50 employees or less, the most productive ones are 17–21 percentage points more likely to be registered and contribute to social security than their least productive peers. At the aggregate level, meager labor productivity growth trends are consistent with the worsening quality of jobs as well.

Several factors increase the cost of production in formal firms, such as high minimum wages, tax wedge, rigid labor laws and regulations, and a large public sector wage premium. This discourages formality, incentivizes atomization, undermines capitalization, and lowers productivity growth.
The level of the average minimum wage in El Salvador is high and has increased, even though real wages in the private sector have declined. The large size of the informal sector means that minimum wages are in general not enforced and may contribute to the segmented nature of the labor market. While almost 80 percent of workers in the informal sector earn wages lower than the minimum wage, only 13 percent of workers in the formal sector do so.

The tax wedge—the difference between the wages paid by the employer and the take-home pay—is high in El Salvador relative to other countries and to the benefits it entails. A high level of the tax wedge can create disincentives to look for a job, and it can depress labor demand by increasing labor costs. These distortions can be exacerbated when the benefits—real or perceived—associated to the contributions are low. The tax wedge of El Salvador is comparable to that of richer economies such as Chile, Switzerland, and Japan. In addition to issues that may affect people’s valuation of future pension benefits, it is important that the quality of the health services provided by the social security system justifies the costs to workers and employers, to foster incentives to contribute. Finally, unlike other countries such as Chile, the system does not include unemployment insurance.

Rigid labor laws and regulations may hurt job creation in the formal sector, especially for women and youth. El Salvador has a high index of rigidity of labor regulations when compared to other Latin American countries. Temporary contracts exist, but their enforceability is not clear. Working hours outside the regular schedule are significantly costlier to employers in El Salvador than in other countries, and adjustments to the individual work schedule require burdensome bureaucratic steps. Part-time employment is penalized for those working 5–8 hours a day. Severance payments and rules are, in general, similar to those of other countries. However, they are high when compared to the costs of informal labor. This implies that workers with weaker attachment to the labor market—such as women and youth—face higher barriers to find a job in the formal sector, as employers are less certain about their true productivity so as to offer them a permanent job given high dismissal costs. This is particularly problematic for women, who are more likely to join the labor force at an older age than men and thereby have to compete for a first job without any previous experience against men of the same age who already accumulated a few years of labor market experience. Moreover, pervasive gender-biased social norms regarding their role as traditional caregivers imply that many of them either leave the labor force or work informally when they have children below the school age. A poor supply of childcare options contributes to this issue.

The high and increasing level of the public sector wage premium may add distortions to the allocation of skilled labor in El Salvador. Workers in the public sector earn wages about 60 percent higher than similar workers in the private sector. This premium is higher for women and older workers. The higher level of the public sector wage for women may affect the capacity of the private sector to hire them by increasing their reservation wages while queueing for a job opportunity in the public sector.

TOWARD CREATING MORE AND BETTER JOBS IN EL SALVADOR

Previous studies of the Salvadoran labor market emphasized the urgency of creating more and better jobs (see, for example, Bashir, Gindling, and Oviedo 2012). This report builds on existing studies by updating key labor market figures and by looking at the jobs issue with new lenses. In particular, it includes a rich analysis of firm dynamics and productivity growth in the private sector, which is key to understand the labor market bottlenecks. In addition, it describes the recent trends in the skill content of jobs using a new methodology that combines the skills’ survey for El Salvador with the traditional instrument to characterize the labor supply.

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3 The ratio of the minimum wage to value added—a common metric used to understand the role of minimum wages in competitiveness—is 0.5 in El Salvador. This level is higher than the world’s average of 0.38. It is also higher than that of several Latin American economies such as Mexico, Panama, the Dominican Republic, Peru, Costa Rica, Colombia, Chile, and Uruguay, where the ratio lies between 0.1 and 0.4 (data source: Doing Business 2019).
The report concludes with policy recommendations to create more and better jobs in El Salvador. Reducing crime and violence is a key condition, but policies in this area are beyond the scope of this report. Crime is fatal for small firms, and it is very costly for medium and large ones. Risks related to crime, at the same time, creates weak incentives to grow, formalize, and gain visibility. Policy recommendations to reduce the incidence of violent crimes are beyond the scope of this report. However, as mentioned throughout the report, the link between crime and poor labor market outcomes goes both ways. In other words, while reducing crime is a necessary condition to spur job creation, it is not a sufficient one. At the same time, when labor opportunities improve—especially for vulnerable youth—crime rates may decline by reducing the incentives to carry out criminal activities. However, a sustained long-term decline in crime depends on whether the wage levels of this group exhibit sustained long-term gains as well.

Thereby, to improve labor market outcomes and reduce crime rates, both economic and crime-related policies are needed. The next paragraphs outline recommendations for the former, organized in two pillars: (a) improving the business environment to increase economic dynamism and (b) reducing distortions in the allocation of labor.

Improving business environment to increase economic dynamism. Suggested policies include (a) streamlining the process to obtain permits and licenses and (b) improving the incentives and capacity of firms to formalize through improving productivity; fostering ICT adoption; fostering financial inclusion of micro, small, and medium enterprises (MSMEs); and professionalizing inspections services without hurting job creation.

Reducing distortions in the allocation of labor. This report identified several distortions that affect the efficient allocation of the country’s most valuable resource, its workers. These distortions artificially inflate the price of labor, which makes it difficult for firms to hire workers or at least to hire them formally. The following are policy suggestions to reduce these distortions:

(a) Adapt the labor code to be relevant to the jobs of the future.
(b) Minimize the unintended negative effects of the Law to Incentivize the Creation of the First Job for Youth.
(c) Make minimum wages consistent with wage levels.
(d) Reduce the tax wedge.
(e) Reduce labor market mismatches.
(f) Reduce the role of gender-biased social norms.

The urgency to create better jobs for new generations and slow down the brain drain cannot be overstated. Over the past 15 years, the enabling environment to achieve these goals has deteriorated exponentially. Policies to foster the growth of a dynamic private sector are crucial. A strong and efficient public sector is essential to help the private sector blossom, by creating and enforcing clear rules and by offering public goods and services that businesses and people are unable to provide. Fostering innovation and growth of new sectors will be crucial in the long term. In the short term, securing the appropriability of investments—both in physical and human capital—is required.

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4 As mentioned previously, the analyses in this report are focused on 2000–2017. Thereby, the policy recommendations may not fully reflect the initiatives that the new government has been implementing or is planning to implement.
Geothermal plant in Ahuachapán, El Salvador
1. MACRO TRENDS IN JOB CREATION AND ECONOMIC GROWTH IN EL SALVADOR

The poor levels of economic and productivity growth help explain the weak process of job creation in El Salvador. This chapter describes the main trends in job creation and economic growth and its sources. It argues that given the current trends, the prospects to create more and better jobs are challenging.

1.1 MACRO CHALLENGES IN EL SALVADOR

El Salvador faces significant challenges in the labor market, many of which may not be obvious when looking at aggregate job figures. The share of the working age population (WAP) with a job is 60.5 percent (Figure 1), only 3 percentage points lower than the average for Latin America. The unemployment rate has hovered around 4 percent since 2011, a very low level by international standards. These average figures, however, hide three important problems that are addressed in this report. First, large inequities exist across socioeconomic groups. Second, the quality of jobs remains poor according to several dimensions such as high levels of informality and low real wage growth. Third, recent trends in labor productivity cast doubts on the capacity of the economy to generate more and better jobs for the large cohorts of young labor market entrants in the near future.

Figure 1
Employment structure of El Salvador and comparator countries

Source: Own elaboration based on Encuesta de Hogares de Propósitos Múltiples (EHPM) 2017 and World Development Indicators (WDI) data.  
Note: WAP defined as 15–64 years.

5 The official unemployment rate is higher, at 7 percent. The differences are in the way the General Directorate of Statistics (Dirección Nacional de Estadística y Censos, [DIGESTYC]) calculates economically active and unemployed populations. Those who did not look for work—because they 1. did not believe there was work, 2. did not know how to look, 3. were tired of looking, 4-7. were waiting for agricultural season—were categorized as active and unemployed by DIGESTYC, whereas International Labour Organization ([ILC]) categorizes them as inactive.
In terms of inequalities among groups, women and youth face worse labor market outcomes than the average Salvadoran. Less than half of them have a job, while 77 percent of men do so (Figure 2). Inactivity, rather than unemployment, explains the low employment rates of women. However, their high inactivity rates—of about 50 percent—may also hide the fact that many discouraged workers may have stopped looking for a job given the low chances of finding one. The unskilled and those living in rural areas also face worse employment outcomes than their skilled and urban counterparts, but the differences are not as wide as those across genders and age groups.

Regarding the quality of jobs, labor market disparities across genders, age, skill, and location also exist. Women and young workers are much more likely to have an informal job than the average skilled worker (Figure 3). While 71 percent and 72 percent of youth and women, respectively, are informal, that figure is 31 percent for the skilled.\(^6\) Women and youth are more likely than men to have part-time jobs, while those

\(^6\) EHPM 2017.
living in rural areas are significantly more likely to have temporary jobs than their peers in urban areas. The largest gaps are across skill groups. Skilled workers have wages more than twice the level of unskilled workers.

Finally, recent labor market and macroeconomic indicators have been static. Labor market outcomes have been stagnant since the early 2000s. The employment rate has not experienced any major changes between 2004 and 2017 (Figure 4). The share of informal jobs remains unchanged at about 70 percent of the total number of jobs, and average real wages declined or remained stable in real terms. In 2017, real wages were on average 3 percentage points lower than in 2004. In comparison, Costa Rica and Panama’s real hourly wages grew by 26 percent and 38 percent, respectively, around the same period.\(^7\)

In addition, the low level of job creation reflects the poor performance in terms of economic growth to some extent. Ever since 2000, gross domestic product (GDP) growth surpassed the 3 percent mark only in 2006 and 2011 (Figure 5). Given the higher rate of population growth, this implies that GDP growth in per capita terms was, on average, 1.4 percent annually. Among the comparator countries, only Mexico had a growth contraction larger than El Salvador.

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\(^7\) The wage growth figures for Costa Rica and Panama come from SEDLAC. They are adjusted to real terms using consumer price index (CPI) data from WDI.
Economic growth is linked to more jobs in El Salvador but not necessarily to better jobs. From 2000 to 2017, a 1 percent increase in GDP was accompanied by an increase of almost 0.9 percent in the number of jobs in El Salvador (Figure 6). This is a relatively strong link when compared to other countries. However, informal employment is considerably more sensitive to economic growth than formal employment: while a 1 percent growth in GDP was accompanied by a 0.8 percent increase in the number of informal jobs, such figure with respect to formal jobs was only about half that value. In other words, while economic growth matters for the number of jobs, it does not necessarily matter for their quality when other barriers affect the creation and access to formal jobs.

The lack of dynamism in the labor market casts doubts on the ability of the economy to generate enough number of decent quality jobs necessary for all future labor market entrants. A simple extrapolation of current labor market trends shows the magnitude of the problem given population projections (Table 1). To increase the employment rate by almost 10 percentage points (from 61 percent to 70 percent) from 2017 to 2030, the economy would need to create almost 900,000 jobs. Given the elasticity of employment to GDP growth, that means that the latter should be, on average, at least 2.6 percent per year until 2030. As a reference, GDP growth has hovered around 1.9 percent since 2000. Most of the jobs to be created would have to be for women and also for youth, since the employment rate for men is currently about 77 percent. A more ambitious goal of increasing the employment rate to 80 percent by 2030 would require the creation of almost 1.4 million jobs and an annual GDP growth rate of 3.9 percent. However, as mentioned earlier, while economic growth might be a necessary condition for job creation, it is not a sufficient one.

While the potential of returning migrants may increase the number of jobs needed to sustain or increase the employment rate, their probability of return is uncertain. A potential concern with the simulations of Table 1 is that they do not consider the possibility of migrants returning home from abroad. In fact, their numbers are very high when compared to the size of the local population. Estimates indicate that the size of the Salvadoran diaspora in the United States is about 2.7 million. However, about 1.3 million of them are US born. Among those born in El Salvador, 35 percent are naturalized US citizens. This means that the number of adult Salvadorans who are not US citizens is about 900,000. While this number of potential returnees is still high, it represents about a third of the often-cited size of the Salvadoran diaspora in the US. Moreover, many of them have children who are US citizens, a factor that may decrease the probability of return.

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**Figure 6**

Employment to economic growth elasticity, 2004–2017

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**Source:** Own elaboration based on WDI.

**Note:** Each point shows the percentage change in the total number of jobs when GDP grows by 1 percentage point. The lines indicate the 95 percent confidence intervals.

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### Table 1
Employment rates in 2030, under different scenarios

<table>
<thead>
<tr>
<th>Current EMP/WAP Share</th>
<th>To increase EMP/WAP share to 80% by 2030</th>
<th>To increase EMP/WAP share to 75% by 2030</th>
<th>To increase EMP/WAP share to 70% by 2030</th>
</tr>
</thead>
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<tr>
<td></td>
<td>Job Growth Rate (CAGR) Needed</td>
<td># Jobs Needed</td>
<td>Job Growth Rate (CAGR) Needed</td>
</tr>
<tr>
<td>Total</td>
<td>61%</td>
<td>3.3%</td>
<td>1,377,161</td>
</tr>
<tr>
<td>Male</td>
<td>77%</td>
<td>344,469</td>
<td>227,668</td>
</tr>
<tr>
<td>Female</td>
<td>48%</td>
<td>1,032,692</td>
<td>900,198</td>
</tr>
<tr>
<td>Youth</td>
<td>45%</td>
<td>511,159</td>
<td>424,059</td>
</tr>
</tbody>
</table>

GDP-Employment Elasticity 0.86

GDP Growth Needed 3.9% 3.3% 2.6%

**Source:** Own elaboration. Projections of the WAP come from the UN Population tables and employment rates are estimated from the EHPM.

**Notes:**
(a) CAGR = Compound annual growth rate; EMP = Employment. (b) The number of jobs needed under each scenario includes both the number needed to maintain the employment rate at 61 percent (440,130 jobs) as well as the additional number of jobs to increase it up to the specific target. The GDP growth needed to create a given number of jobs is estimated using the number of jobs needed and its elasticity to GDP growth.

### 1.2 The Low-Productivity Trap

Low levels of labor productivity and meager productivity growth in El Salvador are behind the weak process of creating more and better jobs. Productivity increases were key drivers of overall economic growth in countries that experienced higher growth rates since the early 2000s, such as Costa Rica and Panama (Figure 7). In El Salvador and Guatemala, GDP and productivity growth were weak. Demographic changes—that is an increasing share of WAP—account for a large share of El Salvador’s economic growth since 2000.

Low labor productivity in the services sector is dragging down overall productivity growth in the economy (Figure 8). The industry sector was the only sector that exhibited productivity growth since 2000. By 2017, value added per worker in industrial sectors was 25 percent higher than in 2000. In contrast, value added...
in agriculture and in services was stagnant and even decreasing. This points out an inefficient allocation of human resources in the economy, since most of the Salvadoran labor force is in services, about 60 percent of workers.

The external sector is an important driver of growth in El Salvador; yet, its benefits are not fully reaped. The share of remittances in GDP hovered around 20 percent over the last 15 years (Figure 9). Only five other countries in the world surpass El Salvador in the level of this indicator. While such large inflows of remittances can help migrant-sending households, there is evidence that remittances also damage competitiveness in El Salvador by raising reservation wages and shifting consumption patterns toward non-tradables (Acosta, Lartey, and Mandelman 2009). Exports are more important and represent about 30 percent of GDP. This figure is relatively close to that of comparator countries such as Costa Rica (34 percent) and Mexico (39 percent). The main export products include services (31 percent of total exports), textiles and furniture (32 percent of total exports), and vegetables and food (17 percent of total exports). The economy is closely linked to the US not only as a source of remittances but also as a trade partner, since it absorbs almost 44 percent of exports. Foreign direct investment remains low at about
1.4 percent of GDP on average over the last 10 years. This is a low level in comparison to other countries such as Panama (9.4 percent), Costa Rica (5.5 percent), Mexico (2.6 percent), and Honduras (5.9 percent).

**Figure 10**
Real effective exchange rate (REER)

G**iven that changing the nominal exchange rate is not an option in a dollarized economy such as El Salvador, improving productivity is crucial to increase the competitiveness in the economy.** Between 2000 and 2009, the Real Effective Exchange Rate (REER) appreciated, driven by domestic prices increasing more rapidly than among trade partners particularly the US (Figure 10). However, the trend started to slowly reverse in 2011, implying that domestic products became relatively cheaper in real terms. However, the REER with respect to the US is still 5 percentage points lower than it was in 2000, indicating that according to this measure of competitiveness, El Salvador’s REER is lower today than almost 10 years ago.

### 1.3 A MACRO FRAMEWORK TO ENABLE JOB CREATION

In summary, aggregate employment indicators show three main challenges for the Salvadoran labor market: improving the quality of jobs, ensuring the inclusion of women and youth, and fostering job creation to keep up with the increase in the number of future labor market entrants. Economic growth has been very low, but even if it reached acceptable levels, it will not necessarily improve the quality of jobs. Aggregate labor productivity growth has been meager, and most workers are absorbed by a service sector whose productivity is stagnant. External factors such as remittances and exports are important contributors to economic activity. However, remittances may also damage the competitiveness the economy needs to create more and better jobs. In terms of labor market outcomes, youth and women are disproportionately affected and face greater constraints for job insertion. Creating an enabling environment to foster investment and productivity growth will be key to boost inclusive economic growth.
Worker at a geothermal plant in El Salvador
2. LABOR DEMAND

The private sector in El Salvador is rather static, with very low entry rates of new businesses, high levels of informality, and low firm growth. This chapter shows that barriers for firms to grow, become more productive, and formalize contribute to explain the poor performance of the economy in terms of creating more and better jobs in El Salvador.

2.1 WHY ARE FIRMS NOT CREATING JOBS IN EL SALVADOR?

Employment patterns suggest employment in El Salvador is disproportionately concentrated among small and large firms, suggesting a missing middle in the firms’ demography. When compared to the more developed countries in the region, El Salvador has a high concentration of employment in small firms (Figure 11). While Panama and Costa Rica have 48 percent and 51 percent of their workers, respectively, in firms with 5 employees or less, El Salvador has 64 percent. At the same time, El Salvador has a high share of employment in large firms when compared to other countries in the region. This share is very similar to that of Costa Rica and substantially higher than that of Mexico. This suggests that El Salvador has a missing middle in terms of the demography of firms, since jobs are concentrated among the very large and very small firms. In fact, the share of employment in firms with 6–99 employees in El Salvador is almost half of that of Costa Rica and Mexico.

The small presence of medium-size firms in El Salvador is related to the dual structure of the economy. Micro firms account for most of the jobs in the informal sector, while large firms absorb most workers in the formal sector. More than 60 percent of formal employment is accounted by firms with 100 employees or more (Figure 12). In contrast, 80 percent of informal jobs are in self-employment or in firms with 4 employees or less. This duality is slightly related to an urban-rural gap in terms of employment structure, but the formal-informal gap is more acute. Some large firms may become visible as informality is not a possibility for them due to their

Figure 11
Employment structure by firm size (formal and informal private sector)

Source: Own elaboration based on EHPM 2017 for El Salvador data, SEDLAC standardization; SEDLAC (Center for Distributive, Labor and Social Studies [CEDLAS] and the World Bank) for comparator countries (May 2018 version).
size. In contrast, some small firms may remain undetected due to the high cost to comply with regulations and the lack of clarity in the benefits attached to being formal.

**High-productivity sectors concentrate a higher share of large firms, whereas low-productivity sectors are mainly occupied by micro and small size firms.** In manufacturing and finance—high-productivity sectors—large firms account for about 60–70 percent of overall sectoral jobs (Figure 13). In contrast, large firms in the agriculture, retail and wholesale, and restaurants and hotels sectors—low-productivity sectors—only generate 10 percent of the overall sectoral employment or less. Notwithstanding, overall employment is highly concentrated in low-productivity sectors such as low-skilled services.

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**Figure 12**
Employment structure by firm size in the private sector

**Source:** Own elaboration based on EHPM 2017.

**Figure 13**
Employment structure by firm size and sector, 2017

**Source:** Own elaboration based on EHPM 2017.
A snapshot of the population of small firms (50 workers or less) in El Salvador suggests that barriers to firm entry and growth are high, both in the informal (that is, unregistered firms) and formal (that is, registered firms) sectors. Among firms with 50 employees or less, most jobs are in older ones. Young firms are more common and employ more workers in the informal sector, indicating that the barriers to entry are higher in the formal sector (Figure 14). But even among unregistered firms, only 6.5 percent of employment is in firms 1 year old or younger (Figure 14, panel (b)). Registered firms 10 years or older account for more than half of formal employment among small firms in El Salvador. Micro firms with 4 workers or less are more prevalent in the informal sector, and they account for a higher share of employment than in the formal sector.

The view of informality as a temporary phase, in which small firms become established and eventually enter the formal sector, does not hold in El Salvador. While the evidence suggests that entry barriers are lower in the informal sector, firms that enter are small and stay small in the long term, since almost 30 percent of informal employment is in micro firms 10 years or older.

The persistently low entry rates of formal businesses coupled with a large number of formal jobs in old firms suggests that the process of creative destruction is almost muted in El Salvador. The entry of new formal firms has been low in El Salvador since 2006. In 2016, the number of new registered businesses was just about 0.5 per 1,000 WAP (Figure 15). This figure is lower than the average for Latin America (2.8) and for every other region except South Asia. Recent trends show that the entry rate has been stagnant since 2006 in El Salvador.

Unlike other countries such as the United States (Haltiwanger, Jarmin, and Miranda 2013) and Vietnam (Cunningham and Pimhidzai 2019) where young and small firms contribute the most to job creation, they play a very small role in El Salvador. In contrast, net job creation in the formal sector is led by incumbent firms that tend to be large (Figure 16). Large firms may be better able to overcome some of the obstacles that are more burdensome to small firms in El Salvador, such as complying with regulations or contracting security services. The number of net jobs created by entering firms is lower than that destroyed by exiting ones, which implies that entry and exit combined led to net job destruction.

While medium-size firms have the highest levels of productivity in the formal sector, they represent only 27 percent of the total number of formal firms and less than half of formal employment. In the formal sector, firms with 10–500 employees have levels of productivity (proxied by value added per worker)
33–63 percent higher than that of firms with less than 10 employees. When comparing firms with otherwise similar characteristics, larger firms are more likely to grow. This means that firm growth patterns are likely to decrease the fraction of employment accounted by medium-size firms. Foreign firms are the most productive, but they do not contribute more than domestic ones to employment creation. Foreign firms have productivity levels 100 percent higher than domestic ones. In contrast, the labor productivity of state-owned enterprises (SOEs) is about 70 percent lower than that of privately owned companies.

**In summary, most jobs in El Salvador are created by micro firms and the self-employed in the informal sector, or by large formal firms.** Low-productivity firms in the formal sector create more jobs than their high-productivity peers. Micro firms in the informal sector do not tend to grow to become medium-size firms or to formalize. This report argues that the high levels of crime and violence, as well as inefficient regulations, are key drivers of the lack of dynamism in the private sector.
The impact of crime and violence on job creation

According to firms in El Salvador, the highest constraint for businesses is crime. This is not surprising considering that the average homicide rate was 58 deaths per 100,000 inhabitants during 2009–2014 (Fundaeungo 2016, 1–12), which corresponds to almost three times the average murder rate in Latin America.\(^\text{10}\) The national homicide rate reached the highest level of 103 per 100,000 people in 2015, making El Salvador the country with the highest murder rate in the world (International Crisis Group 2017), though since June 2019, there has been substantial reduction in crime and violence rates as a result of key efforts of the current government’s administration.

The economic consequences of these high levels of violence could be dramatic. Some estimations indicate that violence costs El Salvador 6 percent of GDP in 2014 (Jaitman et al. 2017), almost 73 percent the annual budget allocated to both public health and education.\(^\text{11}\) Moreover, extortions impose important costs on firms, affecting their labor demand and self-employment in the country. The estimated direct cost of extortions to businesses was about US$756 million in 2014 in El Salvador (Salguero 2016).

Larger firms are more likely to be victims of crime, but when a crime is committed against a firm, it is much costlier for small ones. While firms with 5 employees or more are about 10–14 percent more likely to have been victims of a criminal activity than those with 4 employees or less, the costs of a crime shock represented on average 16 percent of the sales of firms with one worker, but less than 5 percent of the sales of those with 5 workers or more (Figure 17, panel (a)). Accordingly, while larger firms are more likely to spend in security services, this cost represents a much larger fraction of the sales of small firms (Figure 17, panel (b)). The age of the firm is also related to the incidence of crime, as older firms are more likely to experience the burden of crime.\(^\text{12}\)

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10 In 2015, Latin America and the Caribbean was the most violent region in the world, with a homicide rate of 24 per 100,000 inhabitants. As a reference, the global homicides rate is 6 murders per 100,000 population.


12 During an in-depth qualitative interview series with leading companies in El Salvador across key sectors, the manager of one of the most recognized coffee processing and distribution companies in the country mentioned, “We have suffered thefts of their products while transporting them to their clients. We had to hire a criminal investigation firm in order to identify how these thefts are committed, as well as define areas and actions needed to improve internal security measures.” Own elaboration based on qualitative survey collected in May 2019.
The visibility of firms, not only in terms of their size and age but also in terms of their compliance with regulations, is an important predictor of crime victimization among firms. More specifically, registered firms are almost 10 percentage points more likely to be victims of crime than unregistered ones. At the same time, they are 23 percentage points more likely to spend on security services.

Unlike other countries where crime tends to be concentrated in more disadvantaged areas (Sackett 2016), homicide rates in El Salvador are higher in municipalities with greater levels of economic activity. As Figure 18 shows, crime and economic activity are not uniform across the country but concentrated in municipalities in the southeast and central regions. Estimations using official administrative data indicate that municipalities at the top 10 percent in terms of economic activity in 2016 account for 46 percent of total homicides in the country. In contrast, the same figure for municipalities at the bottom 10 percent was 0.8 percent. Moreover, the municipalities of San Salvador (8 percent), San Miguel (5 percent), Soyapango (4 percent), Apopa (3 percent), and Santa Ana (3 percent) were the top five municipalities as a percentage of all homicides in the country and are among the top eight most economically active locations.

This positive relation between crime and economic activity in El Salvador can be explained by the presence and operational preferences of criminal organizations. By 2012, most of the homicides occurring in the national territory are officially attributed to local gangs, which identify and control territories that are strategic for their criminal activities, such as municipalities with good level of economic activity and availability of vulnerable labor force—adolescents and youth—for recruitment.

In addition, this result for El Salvador is consistent with crime patterns in Latin America. According to a profile of victims of crime in Latin America developed by Gaviria and Pagés (2002), these victims tend to live in larger and faster-growing cities. Thus, urban crime in the region reflects the inability of many cities to address the increasing demands for public safety that their urbanization process brings.

However, when comparing crime across municipalities and over time, the results indicate that changes in crime are negatively affecting economic growth. From 2013 to 2016, a 10 percent increase in homicides rates (total homicides) at the municipal level was accompanied by a 0.13 (0.38) percent reduction in economic

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13 We use as proxy for economic activity nightlight intensity at night following Chen and Nordhaus (2010) and Henderson, Storeygard, and Weil (2012).

activity. These results are in line with the findings of existing empirical works for low- and middle-income countries, which identifies a negative relationship between crime and economic growth (Cárdenas and Rozo 2008; Detotto and Otranto 2010; Prasad 2013; Soares 2004).

Crime has an impact on the quantity and quality of jobs. Evidence from a natural experiment (Box 1) shows that a 26.7 percent decline in homicide rates increased formal employment in all firms except large ones by around 2 percent. Moreover, this impact was different by firm size. Estimations indicate that after being exposed to the same crime reduction, micro firms increase formal employment by 5.2 percent, yet the increase by small and midsize firms was 3.3 percent and 3.8 percent, respectively. This result is consistent with the existing evidence on the negative relationship between employment and crime (Lin 2008; Mocan and Bali 2010; Öster and Agell 2007; Raphael and Winter-Ebmer 1999).

Crime also has an impact on the quality of jobs by affecting labor productivity and wages. By using the same natural experiment as before and after excluding large firms, estimations indicate that the reduction in homicides rate increased total salaries paid by all firms in the formal sector by 4.4 percent. This impact was greater for micro firms, which increased salaries by 9.3 percent after the reduction in homicides. Moreover, small and midsize formally established firms increased salaries paid by 6.4 percent and 4.6 percent, respectively. In sum, results for El Salvador support existing evidence on the negative link between legal market wages and crime (Corman and Mocan 2005; Machin and Meghir 2004). A qualitative interview with firms across key sectors in El Salvador also revealed concerns around their ability to fill key middle management positions even though supply of skills was not an issue as shortlisted candidates were unwilling to travel to locations far from their homes due to fear of theft and extortion. The General Manager of a leading agribusiness company located in San Salvador shared, “People like the job, but concerns about personal security plays a large role in their decision to take it up or not. They prefer to look for jobs closer to their homes which makes it harder for us to recruit in the quantities we need to.”

**BOX 1. USING THE 2012 TRUCE TO IDENTIFY THE IMPACTS OF CRIME ON THE LABOR MARKET**

There have been some attempts to address gang violence in El Salvador. One of the most effective—in terms of total homicides reduction—was the gangs’ truce in 2012. It consisted of a non-disclosed negotiation between the Salvadoran government and the two main gangs—Mara Salvatrucha and Barrio 18—that spanned from March 2012 through December 2013. The truce consisted of two phases. In the first one, two main components were negotiated: a ceasefire between rival gangs and reduction of aggressions to security officers—police officers, prison guards, and militaries—and to civilians [FUSADES 2013]. In exchange, the government made efforts to improve conditions for gangs’ members in jail. The second phase of the truce consisted of the creation of the ‘sanctuary municipalities’, wherein gangs committed to reduce theft and extortions.

Figure 19 shows monthly murders in El Salvador for 2011–2016 and the different stages of the truce. Specifically, the truce began in March 8–9, 2012, when 30 jailed mareros were moved from a maximum-security prison to a common one [Valencia 2015]. As shown in Figure 19, the effect was immediate after this: within 24 hours of the start of the truce, the homicide rate dropped by 50 percent, and the daily murders were reduced from an average of 14 to 6—a 60 percent reduction—during the weeks after the truce. Total murders remained low until around the end of 2013. It was not until May 2012 that the Government of El Salvador admitted that a truce was in place [Valencia 2015].

The post-truce period—the end of the truce—started in June 2013, when a new Minister of Defense was appointed. Since the minister disapproved negotiating with gangs, he implemented an important deviation from the truce strategy. Specifically, government officials that participated in the initial negotiation were removed from office. After the truce ended, aggressions against police officers and soldiers rose from May 2014 to similar levels as
in the pre-truce period (Figure 19). In 2015, the government launched another ‘war on gangs’, by redistributing members across the prison system.

To identify the impacts of a crime shock on firms’ decisions and labor market outcomes, we use the truce-driven sharp decline in criminal activity that took place in March 2012. We argue that the timing of this event creates an exogenous variation to the firms and employees for two reasons. First, it was an absolutely political decision [Valencia 2015], very unlikely to be determined by firms or workers. Moreover, once the truce was publicly revealed, it was very unpopular among businesspeople and there is no evidence of the private sector influencing the negotiation with gangs. Second, the secret nature of this negotiation and its immediate effects on crimes—24 hours after the truce started—makes this event clearly unexpected for firms and employees.

We focus our analysis on the pre-truce and truce periods only. We do not use the post-truce or war stages because the unpopularity of this event among businesspeople might have driven the end of the truce indirectly. In addition, given all the media attention around the process and the pressure from the truce’s detractors [Valencia 2015], firms and workers may have expected that this process was not going to be sustainable over time. Therefore, the exogeneity that we claim for the identification may not be valid for post-truce and war periods.

Do inefficient government procedures hurt job creation?

Qualitative surveys suggest that the role of inefficient regulations is key to explain the lack of dynamism in the private sector. Companies interviewed claim that the process to obtain permits and licenses usually takes up to two years to be issued. This seems to be explained by a lack of knowledge of the operability requirements of the sectors by the government authorities, absence of qualified technical personnel at public sector entities, and high levels of bureaucracy at an institutional level. Bureaucratic and cumbersome customs clearance processes and poor road infrastructure are also mentioned as important bottlenecks. Simplifying custom procedures could facilitate employment growth in tradable sectors and in those with strong links to tradable products. Although El Salvador is performing better than its peers in Latin America and the Caribbean in terms of trading across borders, it lags high-income Organisation for Economic Co-operation and Development (OECD) countries by a wide margin. In El Salvador, it takes twice as much time to export and four times as much time to import than among high-income OECD countries.17

Source: Doing Business indicators. The time for border compliance includes time and cost for obtaining, preparing, and submitting documents during port or border handling, customs clearance, and inspection procedures.
Examples for delays and inefficiencies caused due to inefficient government procedures are found across key sectors of the economy. The General Manager of a leading coffee processing and commercialization business in El Salvador mentioned that it has been directly affected by the time, costs, requirements, and bureaucracy associated with the issuance of permits by the relevant ministry for the expansion of their operations in the country. This has affected its growth since it “could not proceed with their expansion plans until all paperwork was properly authorized by the referred institution.” The company shared that in other countries, the time it takes to obtain those authorizations does not exceed more than six months, and in the case of El Salvador, it had to wait up to two years. According to the general manager, “it was not only the length of the wait but the uncertainty surrounding it that prevents us from making concrete strategic decisions with regards to production and exports.” On the other hand, one of the main job-creating plastic processing companies in the country mentioned that it encounters recurrent trade-related obstacles at land borders mainly because of the time it takes to process samples, lack or qualified and knowledgeable customs officials, and absence of unified criteria among border agents and institutions.

An analysis of firms’ own valuation of business constraints confirms the role of crime, informality, customs procedures, and transportation infrastructure as important barriers to private investments and job creation. In particular, the analysis follows the methodology of Carlin and Schaffer (2011) and shows that job creation in labor-intensive sectors is largely affected by corruption, inefficient land regulations, and court systems as well as unreliable electricity.

Inspection systems in El Salvador generate disincentives for firms to grow and become formal. As firms grow in El Salvador, they are more likely to be targeted by inspections from the government. Among firms with 50 employees or more, two out of every three received an inspection over the last year (Figure 20). In contrast, only 23 percent of firms with 5 employees or less were inspected. Among firms that received at least one inspection over the last year, the number of inspections also tends to increase with their size. While inspected firms with 5 employees or less received on average 1.5 inspections, those with 50 employees or more received on average 2.5 inspections.

**Figure 20**
Inspections by firm size, 2016

Source: Own estimates based on World Bank Enterprise Survey (WBES) 2016.

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18 Based on qualitative survey, collected in May 2019.
BOX 2. MAIN BUSINESS CONSTRAINTS IN EL SALVADOR—RESULTS FROM A QUALITATIVE SURVEY

A qualitative survey was carried out in May 2019, before the beginning of the new government’s administration, among 14 firms in key sectors [textile and apparel, agribusiness, contact center, plastics and rubber, paper goods, metal works, footwear, and creative industries] in El Salvador. The five main constraints that companies face to grow in El Salvador include, in order of importance, high level of insecurity (crime and robbery), obtaining licenses and establishment and operating permits, bureaucratic and cumbersome customs clearance processes, lack of skilled labor force, and poor road infrastructure.

Crime

Crime and violence impose costs on the economy directly and also indirectly as they may distort the geographic allocation of human resources. According to one company, this hurts the agribusiness sector particularly, given the difficulty to find skilled staff willing to commute and work to areas that are too far apart from main cities.

Obtaining licenses and permits

Obtaining licenses and establishment and operation permits was also mentioned as a key constraint mainly related to environmental, labor, health, and agriculture permits. Some companies reported that these permits usually take up to two years to be issued and identified that this basically due to a lack of knowledge of the operability requirements of the sectors by the government authorities, absence of qualified technical personnel at public sector entities, and high levels of bureaucracy at the institutional level.

Another company indicated the excessive time taken by two relevant ministries to issue phytosanitary permits for imports from Brazil and Italy of raw and intermediate material needed for the production and assembly of high-quality products. This has led to significant problems for the company in international business negotiations and strategic decisions to integrate in global value chains.

Bureaucratic and cumbersome customs clearance processes

All of the manufacturing companies interviewed trade within the region and move their products by land. Bureaucratic and cumbersome customs clearance processes was mentioned as a key constraint to growth and job creation because of high paperwork requirements, poor customs infrastructure at land borders, lack of unified evaluation criteria between border agencies, and obsolete trade facilitation regulatory framework that is currently being used. For these companies, this is a major issue since all of them import raw and intermediate goods needed for the production process of the products that they subsequently export.

Lack of skilled labor force

The lack of skilled labor force was also cited as a limitation, since the curricula and careers offered by technical institutions and universities do not tend to follow global trends, as well as firms’ needs and requirements. All companies included in this report stated that this has been an issue that affects their operation in the country since they have had to tweak their business model to adapt it to the availability of the human resources. For example, the contact center sector has developed its own training schools to develop and ‘fine-tune’ the skills needed and requested by specific clients. While this works as a solution in the short term, it also means that companies are not able to take advantage of lower-cost skill formation through economies of scale.

The most common areas that need to be fulfilled include English language proficiency, improvement of technical abilities and curricula in engineering- and math-related fields, information technology, and other sector-specialized areas [plastics, footwear, paper goods, textile]. Other skills to be improved are socioemotional in nature and relate to leadership, teamwork, and customer service.

However, all companies interviewed have training programs for their staff, which are provided both internally and externally. In the case of external training programs, 79 percent of them are offered by public and private institutions. In the case of public institutions, the Instituto Salvadoreño de Formacion Profesional [INSAFORP] is the one used by most businesses; in the case of private institutions, companies mentioned that these programs were
offered by various organizations, depending on the area to be taught. The most common topics included training programs related to technological certifications (CISCO, Microsoft, and Six Sigma), soft skills (leadership, conflict management, teamwork), hard skills (analytical capacity, innovation, robotics), English as second language, use of computer programs, good manufacturing practices, and occupational security, among others.

**Poor road infrastructure**

Poor road infrastructure was also highlighted by many companies as a weakness that has not been properly addressed by government officials. According to the companies, the lack of proper maintenance and construction of additional entry points to and out of the main industrial areas poses a permanent threat to their operations, since personnel and products have to endure daily endless traffic-related situations to mobilize into and out of these areas.

**Export barriers**

The exporting companies report encountering issues mainly related to lack of enforcement of trade facilitation policies, absence of government support in the identification of new commercial partners, and lack of legal certainty to businesses already operating in the country.

Concerning lack of enforcement of trade facilitation policies, most of the 14 companies reported that they have encountered restrictions to export their products and have also been directly affected by them. The main limitations that persist include excess import and export paperwork and high bureaucracy as well as lack of homologation of criteria among customs agents (Customs and Ministry of Agriculture) at border points, among others. The companies claim that customs management lacks professional and well-trained officials, as well as standardized criteria among the different entities that intervene in the export process, making it costlier and time consuming for businesses to trade.

Another issue has to do with the absence of government support in the identification of new trade partners. Companies typically rely on specialized government institutions that provide updated information and contacts regarding potential export and investment opportunities abroad; these institutions are either part of the Ministry of Foreign Affairs or the Ministry of Economics. Some companies mentioned that they have had to do their own assessment of potential markets and clients due to the weakness of institutions to provide them with information regarding sectoral trends, potential trade shows, and business opportunities, just to mention some.

An additional constraint identified by companies has to do with the lack of legal certainty that businesses already operating encounter in the country. Some of the companies interviewed complain about the negative impacts that arbitrary changes in the implementation or regulations affect their businesses.

**High and increasing minimum wages may hurt the expansion of formal firms and contribute to the dual nature of the labor market.** The level of the minimum wage is high and has increased, even though real wages have declined in El Salvador, which has different levels of minimum wages by broad sectors of economic activity. In 2015, the average minimum wage in the economy represented almost 80 percent of the average wage. After the increase in the minimum wages of 2018, that figure increased to almost 97 percent. The large size of the informal sector means that minimum wages are in general not enforced and may contribute to the segmented nature of the Salvadoran labor market. While average minimum wages in the formal sector represented about 71 percent of the average wage, that figure was 133 percent in the informal sector. As a result, while almost 80 percent of workers in the informal sector earn wages lower than the minimum wage, only 13 percent of workers in the formal sector do so (Figure 21, panel (a)). Enforcement of minimum wages also seems higher among larger firms. More specifically, while about 28 percent of workers in formal firms with 1–4 employees earn wages lower than the minimum wage, this figure was only 11 percent among firms with 100 employees or more (Figure 21, panel (b)).
Unleashing firm entry and growth in El Salvador

When firms grow and enter the formal sector in El Salvador, they are more likely to be targeted by crime and by government inspections, and they face burdensome procedures to register new operations or activities. Most firms seem to have only two options: to enter small and stay small in the informal sector, or to have a large-scale operation in the formal sector. The role of midsize formal firms in job creation is minimal—even when compared to other countries in the region—despite having the highest levels of labor productivity in the country. Identifying the role of crime and government procedures helps narrow down the set of policy recommendations to boost private sector job creation in El Salvador.

2.2 WHY IS THE QUALITY OF JOBS DECLINING?

Increasing the quality of employment is one of the biggest challenges faced by the labor market in El Salvador. This section considers informality and wage levels as the relevant measures of employment quality. Raising wages and reducing informality is a complex task that has many facets. Improving productivity in the private sector is a key component of this task. When productivity increases, wages tend to do so as well. Productivity gains allow firms to reach a minimum threshold at which it becomes feasible to become formal. This process reinforces a virtuous cycle, since being formal is often associated with important benefits such as better access to finance, which allow firms with growth potential to achieve their goals.

The quality of jobs has declined in El Salvador

Trends in informality and real wages show that the quality of jobs has declined in El Salvador. Informality rates have been stagnant at 70 percent of workers since 2000 and increased significantly for women and youth (see Chapter 3). Informality among the unskilled is almost universal. In fact, the overall rise in informality was driven by skilled workers (Figure 22). Real hourly wages in 2017 were 2.7 percent lower than in 2004 (Figure 23). Such decline was driven by prime-age and male workers, who suffered a decline of about 7.8 percent and 5.8 percent during that period, respectively. Women and youth experienced a wage increase but, since they represent a marginal share of workers, this did not have a significant impact on the overall wage trends.
Does poor job quality reflect low labor productivity? Yes!

The quality of jobs in El Salvador is low and trapped in a vicious cycle, where low-productivity firms are not able or lack the incentives to become formal. Formalization is not feasible for most of them, and the benefits typically associated with formality—such as better access to finance—are not clear. Moreover, regulations in the formal sector tend to be burdensome, adding inefficiencies and hurting the productivity of firms more subject to surveillance by the enforcing agencies.

Low levels of labor productivity could help explain why labor demand has weakened and the quality of jobs has declined in El Salvador. According to economic theory, the demand for labor increases with the value of workers’ productivity. In fact, average wages in El Salvador are higher among firms with high levels of labor productivity. Among a sample of formal firms, those in the top quintile of labor productivity pay wages eight times higher than those in the bottom quintile (Figure 24, panel (b)). These patterns do not change substantially when comparing firms of the same size, age, ownership, and sector, among other characteristics. Even among a sample of unregistered firms, the correlation between labor productivity and wages is positive.
and strong (Figure 24, panel (a)). Moreover, it holds for workers of different skill levels. In particular, low- and high-skill workers in the top quintile of labor productivity earn wages 1.6 and 1.4 times higher than their peers in the bottom quintile.

Several mechanisms help explain the vicious cycle of low productivity and informality, which traps workers in low-wage jobs. First, higher productivity allows firms to reach the profitability threshold beyond which complying with regulations is feasible. In fact, as firms become more productive, they are more likely to register and pay social security contributions for their employees in El Salvador. Using a sample of formal and informal firms with 50 employees or less, those in the highest productivity quintile are 21 percentage points and 17 percentage points more likely to be registered and pay social security contributions for their employees, respectively, than their peers in the lowest productivity quintile (Figure 25).

![Figure 24](image)

Source: Based on CONAMYPE survey 2017.

and strong (Figure 24, panel (a)). Moreover, it holds for workers of different skill levels. In particular, low- and high-skill workers in the top quintile of labor productivity earn wages 1.6 and 1.4 times higher than their peers in the bottom quintile.

Several mechanisms help explain the vicious cycle of low productivity and informality, which traps workers in low-wage jobs. First, higher productivity allows firms to reach the profitability threshold beyond which complying with regulations is feasible. In fact, as firms become more productive, they are more likely to register and pay social security contributions for their employees in El Salvador. Using a sample of formal and informal firms with 50 employees or less, those in the highest productivity quintile are 21 percentage points and 17 percentage points more likely to be registered and pay social security contributions for their employees, respectively, than their peers in the lowest productivity quintile (Figure 25).

![Figure 25](image)

Source: Based on CONAMYPE survey 2017.

Note: Each bar shows the difference with respect to the first quintile.
The low levels of productivity in the private sector imply that the costs of formalization are prohibitive for small firms in El Salvador. Taking the case of an informal entrepreneur who has annual sales of about US$1,500 (that is, in the bottom 20 percent of the sales distribution from the sample) and employs one worker, he or she would have to pay fees19 for an amount equivalent on average to 116 percent of the annual sales (Figure 26). In addition, the costs of hiring a professional to pay taxes20 and the social security contributions of formalizing a worker at the minimum wage,21 would be equivalent to 44 percent and 53 percent of the annual sales, respectively. Overall, this implies that these costs involved with the formalization of a business would amount on average to more than three times the level of annual sales for a low-income entrepreneur. The costs are also large for informal firms in the second and third quintiles of the sales distribution. With limited access to finance, it would be unfeasible for most entrepreneurs to find the liquidity to afford these high costs.

Second, competition from informal firms may lower the incentives and the capacity of formal firms to comply with costly regulations. Firms in El Salvador claim that competition from informal firms is the second most important barrier to do business (Figure 27). While both formal and informal firms benefit from certain public goods, only the former contribute to pay for them through taxes and fees. This represents an uneven playing field, which may prevent formal firms to expand and create formal jobs.

Among firms with 50 employees or less in El Salvador, the incentives to formalize are clear for exporting firms, but less so for those who intend to apply for credit. Estimations show that exporting firms are significantly more likely to be registered and to contribute to social security on behalf of their employees (Figure 28). However, when comparing firms with otherwise similar characteristics, firms that export are no more likely to contribute to social security than non-exporters. This is consistent with the incentives’ hypothesis, since they do not need to contribute to social security on behalf of all their employees to export their goods and services, but they do require to be registered for exporting purposes. It is important to mention that this sample of firms does not include the main large exporters of El Salvador but only those with a small-scale exporting

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19 According to the Doing Business indicators, the fees associated with starting a business in El Salvador are equivalent to 45 percent of GDP per capita, that is US$1,753.

20 According to the Doing Business indicators, paying taxes requires 180 hours of work. At the average hourly wage of a high-skilled worker (US$3.76), this amounts to US$676.80.

21 The additional costs of formalizing an existing worker who already earns the minimum wage is calculated as the additional amount of social insurance contributions, which is equal to 22 percent of the annual minimum wage, where 22 percent is the tax wage for low-wage workers.

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Figure 26
Costs of formalization for small firms, relative to sales
activity, sometimes of a rather informal nature. For instance, the survey asks entrepreneurs if they had traded goods through the official procedures, through ‘encomenderos’ or personal travel.

Moreover, access to finance does not seem to be a strong incentive for firms with 50 employees or less to become formal in El Salvador. The share of firms that are registered or contribute to social security is roughly the same or even lower among firms that applied for credit when compared to those that did not. When comparing firms with otherwise similar characteristics, those that applied to a loan are consistently less likely to be formal than the rest. However, this hides an important feature of financing options for small firms in El Salvador. Only 37 percent of small firms that applied and obtained credit did it through private banks (Figure 29). They have higher rates of formalization (37 percent) than firms without access to finance (23.5 percent). However, most firms that claim to have obtained credit (63 percent) did so through other channels.
that have weaker requirements, such as cooperative banks, individuals, and family members. Informal lending institutions often rely on personal connections, a co-signer, or a collateral to secure the loan. These firms tend to be informal, which means that they are unlikely to go through an assessment of their risk and proper coaching about the use of the funds. Access to finance in El Salvador is low also when compared to its neighbors: while less than 30 percent of adult Salvadorans have an account at a financial institution, that figure is 42 percent or higher for Honduras, Panama, and Guatemala, and almost 68 percent in Costa Rica.22 To some extent, the low level of account ownership reflects the low incidence of formal salaried jobs.

**What are the main constraints to firms’ productivity growth?**

Reducing informality requires not only improving the incentives but also identifying what constrains productivity growth. The previous section discusses the barriers that firms face in El Salvador to enter and grow. These barriers not only affect their employment creation but also the quality of such employment. Episodes of structural transformation involve a shift in employment from low- to high-productivity firms and sectors, which contributes to economy-wide productivity growth. In El Salvador, these shifts in employment are muted and move in the opposite direction (Figure 30). From 2005 to 2016, less-productive sectors such as hotels, restaurants, and domestic services expanded their share in total employment, while more-productive sectors such as finance, manufacturing, transport, and information and communication technology (ICT) shrunk theirs. Identifying the barriers faced by sectors such as finance, manufacturing, transport, and ICT is crucial to foster the growth of better jobs in El Salvador.

The fact that the most-productive firms are the ones that create less jobs is consistent with the weak structural transformation of El Salvador. Firm dynamics in the formal sector suggest the existence of distortions in the allocation of labor, as the most productive firms are less likely to grow and create jobs than their least-productive peers. Employment creation among formal firms in the top productivity quartile is about 14 percent lower than that of the least-productive firms (Figure 31). In contrast, formal firms that exit tend to be less productive. In particular, firms in the top-productivity quartile are 38 percent less likely to leave the market than their least-productive peers. This suggests that firm exit contributes to improve overall productivity levels.

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When formality is associated with more rigid regulations, it may affect productivity and employment growth. When restricting the sample to firms in typically private high-productivity sectors (manufacturing, transport and ICT, and finance), the two sub-sectors that experienced the largest changes in employment between 2005 and 2017 were food products (grew) and clothing (shrunk). Both sectors are intensive in unskilled work, yet both had very different trajectories (Figure 32). Another dimension where both sectors are different is in the incidence of informality. While 56 percent of employment in clothing is formal, that figure for employment

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23 Excluding public sector, utilities, and mining.
in food products is only 41 percent. As mentioned earlier, the high costs of complying with regulations are burdensome to the private sector, particularly for small firms such as those in the food industry. In contrast, as shown in Chapter 3, the cost of hiring high-skill labor has declined both in relative and absolute terms, and its supply increased.

**Barriers to adopt new technologies drive down productivity.** Small firms that use digital technologies in El Salvador are more productive, more likely to export their goods and services, and more likely to be registered, and they pay higher wages than the average small firm. More specifically, small firms that use the internet have productivity levels about 30 percent higher and pay wages 12 percentage points higher than those that do not have access to internet. Internet access is also associated with being an exporter firm (by 4 percentage points) and with being formal (by 18 percent). Most small firms in El Salvador that use the internet do so through a mobile device. Those that also use a computer or tablet have productivity levels 21 percent higher than the rest. These results control for other differences across firms, such as age, size, location, sector, and characteristics of the owner.

Despite the significant productivity gains associated with ICT, most small firms in El Salvador are not connected. Out of every 10 small firms in El Salvador, 8 firms did not use any internet connection during the past year (Figure 34, panel (a)). While according to the WBES, 42 percent for firms in El Salvador have their own website, the sample excludes firms with 4 employees or less, which represent almost 90 percent of small firms (and 64 percent of employment). When considering internet penetration among people, El Salvador has very low levels of connectivity not only in absolute terms but also in comparison to other countries in the region or at the same level or economic development (Figure 34, panel (b)). This is despite the fact that the cost of mobile broadband services relative to average income levels in El Salvador is roughly the same as that of Latin America and even lower in absolute terms (World Bank 2016).24

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24 This is consistent with El Salvador being a laggard in terms of innovation. According to the Global Innovation Index (Cornell University, INSEAD WIPO 2019), El Salvador ranks 96 out of 129 nations (infrastructure).
Breaking the cycle

The quality of jobs has been rapidly declining in El Salvador. This reflects a vicious cycle, where low productivity leads to lower wages and informality, and where formality is costly and does not bring about important benefits. At the same time, competition from informal firms also poses an important barrier to the creation of formal jobs.

Besides discouraging firms to be formal, rigid regulations may hurt the capacity of formal firms to create jobs. The costs of complying with the regulations of the formal sector are prohibitive for several firms. At the same time, one of the main benefits—access to finance—is almost nonexistent. This is in addition to other, maybe more important, barriers—such as the high levels of crime and violence, inefficient inspection systems, poor infrastructure, and so on—which may affect not only job creation but also productivity and the quality of jobs.
Improving the quality of jobs requires raising labor productivity, reducing the costs, and improving the benefits of being formal. Raising productivity involves eliminating distortions that prevent labor from reallocating from low to high productivity sectors and improving the capacity of productive firms to create more jobs. Barriers to technology adoption among firms and individuals are associated with lower productivity.
Students at a computer repair and maintenance workshop in Zaragoza, El Salvador
3. LABOR SUPPLY

3.1 IS THE LACK OF SKILLS A BARRIER TO JOB CREATION?

Firms in developing countries often cite the lack of skills as one of the main barriers to expand their operations, and El Salvador is not an exception. According to USAID (2017), the lack of skills is a key obstacle to local and foreign businesses in El Salvador. The WBES for El Salvador shows that one out of every four businesses claims that an inadequately educated workforce is a major constraint in El Salvador. Also, according to the qualitative survey carried out for this report, firms report that the lack of skills is also a key barrier to grow. Consistent with this hypothesis, the labor market prospects of the skilled are much better than those of their less-skilled peers: while around 80 percent of college graduates are employed, only 64 percent of those who did not complete high school have a job.

Despite these concerns about the scarcity of skills, recent trends in the educational attainment of Salvadorans show important improvements. From 2002 to 2017, the number of tertiary education graduates per 1,000 inhabitants more than doubled (Figure 35, panel (a)). Accordingly, the average number of years of education of young adults (ages 21–30 years) increased in almost every year during 2000–2017. El Salvador is also not lagging significantly when compared to other countries in the region. The average number of expected years of education—both in absolute terms and quality-adjusted terms—is slightly below the median value of comparable countries.

Figure 35
Educational attainment

Source: The number of tertiary education graduates comes from UNESCO, the total population comes from WDI, the number of years of education comes from the Human Capital Index (HCI).

25 The corresponding figures for comparator countries are Panama (18.9 percent), Mexico (30.9 percent), Costa Rica (38.3 percent), Honduras (35.1 percent), Nicaragua (17.4 percent), and Guatemala (32.5 percent). Source: WBES 2016 [http://www.enterprisesurveys.org/Custom-Query, accessed on March 7, 2019].

Skills: Demand, supply, or mismatch issue?

The evolution of the supply and demand of skilled labor suggests labor market mismatches. A simple model of labor demand and supply suggests that if the demand for college graduates was increasing at the same pace as their supply or more, their relative wages would be expected to increase as well or, at least, remain stable. In contrast, the evidence shows the opposite. Real wages increased for every educational group except college graduates since 2010 (Figure 36, panel (a)). In fact, the latter is the only group that experienced real wage decline. This is not driven by changes in other workers’ characteristics, since the skill premium associated with having tertiary education declined since 2007 for both men and women even after controlling for other factors such as age, gender, education, region, type of employment, type of firm, and sector (Figure 36, panel (b)). While college-educated men and women were expected to earn wages approximately 75 percent and 45 percent higher than their peers who had not completed primary education in 2007, by 2017, those figures were 36 percent and 32 percent, respectively.

However, diplomas are not always synonymous of skills in El Salvador. Differences in teacher education quality and on-the-job learning as well as in other individual factors imply that individuals with the same degree may have a completely different set of abilities. Several of these abilities are difficult to measure and observe by prospective employers. In addition to quality challenges in education, this situation reflects the absence of a fully operational and well-articulated certification system and competencies and qualifications matrix aligned with private sector demands. Currently, INSAFORP and the Ministry of Education and Science and Technology are responsible for certifying competencies. Most recently, the government had carried out efforts in establishing a National Coordinating Council of Technical Education and Training to help establish a national certification system as a first step forward in strengthening the current system; however, it is still in the early stages.27

The existence of a survey based on the Skills Toward Employment and Productivity (STEP) surveys for El Salvador allows to measure some of these skills, by creating indexes of the task content of jobs of different occupations.28 Broadly, skills are classified into five groups: non-routine (analytical, interpersonal, and manual) and routine (cognitive and manual). Non-routine skills are typically known as the skills of the new economy, as they tend to complement new technologies. These skills include, for example, creativity and critical thinking (analytical), teamwork (interpersonal), or non-repetitive manual tasks. These are embedded in high-skilled occupations, such as managers or architects, and also in manual jobs such as chefs or other services occupations. In contrast,  

27 Financed through the FOMILENIO II Program financed by the Millennium Challenge Corporation (MCC), United States of America, and the Government of El Salvador.
28 This follows the methodology of Lo Bello, Sanchez-Puerta, and Winkler (2019).
Routine skills are easier to automate and thereby to decline as countries get closer to the technological frontier. They not only include low-skilled workers such as those in the assembly line but also middle-skilled ones such as accountants or copy editors, as some of the tasks they carry out can be done by computers.

In contrast to what is observed in most countries—both developed and developing—nonagricultural jobs became more intensive in routine cognitive skills in El Salvador (Figure 37, panel (a)). Some of the occupations leading this trend are in security and sales. These occupations, unlike what is observed in other economies, tend to be associated with higher wages when comparing workers with similar levels of experience and education in El Salvador (Figure 37, panel (b)). Consistent with evidence from other economies, jobs with a high content of high-order analytical skills (new economy skills) such as those intensive in math or critical thinking have, on average, higher wages. However, the share of jobs intensive in the skills of the new economy (that is both analytical and interpersonal skills) declined since 2000. Some of these jobs include chief executive officers, doctors, and scientists and also drivers and electricians. The only change consistent with that experienced by other countries is the decline in the routine manual intensity of tasks, which mostly include manual work in manufacturing.

**Public sector wage premium**

The high and increasing level of the public sector wage premium may add distortions to the allocation of skilled labor in El Salvador. Public sector jobs, as a share of the total number of jobs, hovered around 8 percent since 2010. Public sector wages in El Salvador continue to be about twice the level of the average wage in the private sector (Figure 38, panel (a)). When controlling for the fact that public and private sector jobs differ in terms of skills, experience, and gender composition, the public sector wage premium is lower, but it is still high at almost 60 percent and has increased since 2008. The public sector wage premium is higher for women and older workers (Figure 38, panel (b)). The higher level of the public sector wage for women may affect the capacity of the private sector to hire them by increasing their reservation wages while queueing for a job opportunity in the public sector.

![Figure 37](image-url)

*Source:* Skill content of jobs indexes created using the STEP-like survey for El Salvador combined with EHPM (SEDLAC standardization) for trends over time; wage skill premium calculated using EHPM data (SEDLAC standardization).

*Note:* Changes in the skill content of jobs are driven by changes in the occupational structure of the labor force.
What do migration patterns tell us about skills?

A weak demand for skills, large out-migration, and brain drain are part of a negative cycle in El Salvador. Between 2000 and 2017, the number of Salvadorans in the US increased from about 800,000 to about 1.4 million people—a 75 percent increase. Patterns of international migration provide suggestive evidence that future increases in the educational attainment of workers will not be a sufficient condition to solve the labor market challenges in El Salvador, as they are more likely to migrate to the US than the average Salvadoran (Figure 39). The fact that emigrants from the Northern Triangle are positively selected into migration is confirmed by existing studies. For example, Hasbun and Sousa (2018) find that Salvadorans who migrate would have higher earnings at home than those who do not migrate. This may also help explain the decline in the returns to a college degree. While more than half of Salvadorans ages 25–64 years have at most 8 years of formal education, 70 percent of their counterparts who moved to the US in the last 5 years have 9 years of education or more. In other words,

Figure 38
Public sector wage premium

Figure 39
Educational structure of Salvadorans at home and abroad

Source: The educational structure of Salvadoran migrants in the US was estimated using the American Community Survey (ACS) for 2017. Recent migrants are those who migrated to the US within the last 5 years. The skill groups are classified as low (less than 9 years of education), middle (9–13 years of education), and high (14 years of education or more). Sample includes people of ages 25–64 years.


Salvadorans who migrated to the US over recent years are more likely to be more skilled relative to those left behind. Estimates suggest that the human capital lost associated with a 10-year outflow of adults—in terms of foregone local wages—represented 1.9 percent of GDP in El Salvador (Del Carmen, Hasbun and Sousa 2018).

In the case of the US and El Salvador, different labor market prospects are a crucial driver of migration decisions. There are important gaps in terms of employment opportunities between these two economies and even larger ones in terms of lifetime wage gains (Figure 40). These gaps vary substantially across genders, ages, and skills. While prime-age Salvadoran men have employment rates about 4 percentage points higher in the US than in El Salvador, Salvadoran women have employment rates more than 10 percentage points higher in the US than at home. These gaps in employment opportunities tend to be larger also for unskilled and particularly for young Salvadorans (by about 17 percentage points). In the case of wages, the differences are more dramatic (Figure 40, panel (b)). For example, while prime-age men earn an average monthly wage of US$656 in El Salvador, that figure for Salvadorans living in the US is US$2,813. These wage differentials are larger for unskilled workers: the gaps are equivalent to 288 percent and 165 percent of low-skill and high-skill wages in El Salvador, respectively.

Despite these large wage gaps, empirical evidence shows that even modest wage gains in migrant-sending countries can have significant effects on reducing out-migration, since people have a strong preference for living at the home location. For example, even though the average wage in the US is at least 900 percent higher than that of Mexico (International Labour Organization 2018), just a 10 percent increase in Mexican wages reduces migration rates and durations by a large magnitude.\footnote{To some extent, migration itself may contribute to balance future outflows, since wages in migrant-sending countries tend to increase as workers become scarcer (Bouton, Paul, and Tiongson 2011; Elsner 2013). However, to generate sustained wage growth and strengthen labor demand in the long term, a continued increase in labor productivity is crucial.} 30\footnote{30 In particular, it reduces the number of years spent in the US by about 5 percent (Lessem 2018).}

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**Figure 40**
Labor market gaps for Salvadorans in the US and at home
Salvadoran workers have some of the skills required to transition out of agriculture, but they find these jobs abroad. While 2 out of every 10 jobs in El Salvador are in agriculture, less than 2 percent of Salvadorans who migrate to the US are in that sector (Figure 41). While some Salvadorans may lack the skills for a job outside of the primary sector, the fact that most of them are able to find jobs with skills requirements very different from those of a farm job in the US suggests a different hypothesis. Salvadorans in the US not only work in sectors intensive in manual skills such as construction, restaurants, hotels, and commerce (45 percent versus 35 percent in El Salvador), but also in sectors with mid- to high-skill requirements such as health and education and business support services (25 percent versus 9 percent in El Salvador).

3.2 WHICH FACTORS CONTRIBUTE TO THE GENDER AND YOUTH GAPS?

Women and youth have not experienced significant improvements in their labor market outcomes over the past decade. Almost 80 percent of women and people ages 15–24 years have an informal job. In contrast, the share of men ages 25–49 years with an informal job is almost 20 percentage points lower. These patterns are slightly different when controlling for workers’ characteristics such as education and region. Women and youth are about 9 percent and 17 percent more likely to be in informal jobs than males and prime-age workers with similar observable characteristics, respectively. Older women are the ones with the highest incidence of informal work in El Salvador. Eight out of every 10 women ages 50–64 years do not contribute to social security. This may increase their risk of old-age poverty substantially as they approach the retirement age.

Informality rates have risen since the early 2000s, particularly for young women. Informality remained high at almost 70 percent of salaried workers since 2000 (Figure 42). However, there was an increase among
women, particularly for young ones. More specifically, the share of informal jobs increased by about 7 percent and 5 percent for women ages 15–24 years and 25–29 years, respectively.

**Informal work among women and youth in El Salvador is high not only with respect to that of other demographic groups but also relative to women and youth in other countries in the region.** While 70 percent or more of all young and female workers in El Salvador have an informal job, this rate is about 50 percent or less in Mexico, Costa Rica, and Panama.

The scarce opportunities for young Salvadorans are accompanied not only by joblessness but also by poor human capital accumulation and poverty. El Salvador has one of the highest rates of NEETs (youth Not in Education, Employment, or Training) in the region. Almost one out of every three young Salvadorans are not working or in school, while this figure for Costa Rica, Panama, and Mexico is 20 percent. In addition, 47 percent of young NEETs are poor, of which around 23 percent belong to the lowest two income quintiles, above the average national extreme poverty in the country of 7 percent. Moreover, this group has low education attainment...
with 42 percent having incomplete primary education. Young women living in rural areas are the demographic group with the highest NEET incidence: while almost 60 percent of women ages 25–29 years are not working or in school, just about 6 percent of young men are in the same situation. In other words, the issue of NEETS is, to a large extent, a gender and rural issue. However, while women in rural areas may not be working outside the home and thereby be classified as not working, these statistics hide important disparities about the division of unpaid work at home across genders. In fact, PNUD (2018) finds that young women contribute 26.1 percent of the total number of unpaid working hours at home in El Salvador, while young men contribute only 6.8 percent. Young women contribute even more in rural households, about 29.3 percent of the total number of unpaid hours of work at home. Educational attainment is also an important part of the story for female NEETs. While 19 percent of women with 14 years of education or more are NEETS, the corresponding figure for those with 8 years of education or less is 54 percent.

**Young workers are not entering the labor market and engaging in the occupations of the ‘new’ economy.** In most countries for which there are comparable data, the increase in the share of jobs intensive in the tasks that complement new technologies (such as non-routine cognitive and manual) is often driven...
by young labor market entrants. In El Salvador, the opposite is true. Young workers are more likely to be in occupations intensive in routine skills that can be more easily replaced by digital technologies (Figure 45). This is consistent with the evidence reported in Chapter 2, which shows that the economy lags significantly when compared to the region in terms of technology adoption in the private sector. While job creation—even in routine jobs—is crucial for El Salvador, this could also be a reflection of the low-productivity trap where firms faced barriers to adopt technology, which depresses the demand for the skills complementary to those technologies (which tend to be associated with higher productivity and wages) and thereby the incentives for young workers to acquire them. It can also reflect that these skills are either acquired through work experience or must be signaled through a diploma.

**Gender-biased social norms could help explain gender gaps**

**Differences in the school-to-work transition between men and women may help explain their subsequent differences in labor market outcomes.** The gender gap in the labor market is visible as soon as age 15, when the labor force participation of men is about 30 percent, while that of women is slightly above 10 percent. Men’s labor force participation increases above 80 percent at about age 20, while women join the labor force later. Women get married at a very young age on average (age 19.9 years in 2008), compared to other developing countries such as Turkey, Bulgaria, Mexico, and Chile (where the age of first marriage for women is about 25 years or older). At the average age at which women complete their education and may start looking for a job, they have less labor market experience than men. Their labor force participation and employment peaks at about age 40 and quickly declines afterward.

**The traditional role of women as caregivers as well as the lack of childcare options and flexible employment regulations may help explain their higher informality incidence.** Women whose youngest child is one year old or younger are 18 percentage points and 16 percentage points less likely to participate in the labor market and to have a job, respectively, than women without children (Figure 47). This gap is smaller for women with older children and vanishes when the youngest child reaches the school age. In contrast, the employment outcomes of men are basically the same regardless of the age of their children. Having children is also correlated with the job characteristics of women employed. In particular, female workers whose youngest

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**Figure 46**
School, marriage, and work over the life cycle, 2017

Source: Author’s calculations based on EHPM 2017.

child is four years or younger are more likely to work part-time or to have an informal or part-time job than their counterparts without children.

**Do labor laws contribute to gender and youth gaps?**

The higher informality rate of wage employment among women and youth is likely to be driven by exclusion. Informality is often associated with lower-quality jobs, not only in terms of being unprotected against important risks but also in terms of earning lower wages. Socioeconomic groups with a weaker attachment to the labor market are more likely to be segregated when the bureaucratic costs of formalizing workers are substantial to employers. Given that women and youth have a more limited record of labor market performance, employers are more uncertain about their true productivity than they are with respect to candidates with a lengthier record. At the same time, if regulations regarding flexible forms of work—such as part-time or working from home—are not clear or costlier, women and youth in school or with family responsibilities have even poorer prospects of having a first job.

The higher incidence of informality among female and young salaried workers could reflect the fact that laws and regulations do not contemplate the type of labor arrangements better fit for workers with weaker ties to the labor market. Women and youth are more likely to hold nonstandard jobs. While 38 percent of young workers have a temporary job, between 25 percent and 27 percent of those ages 25–49 years are in the same situation (Figure 48). Female and male young workers are 8 percentage points and 17 percentage points more likely to have a part-time job than their counterparts ages 25–29 years. Women ages 25 years or older are about 10 percentage points more likely than their male counterparts to work part-time. Finally, 44 percent of self-employed women work from home, while only 14 percent of their male counterparts do so. These gaps in nonstandard job holding also exist when comparing workers with the same levels of
education and living in the same region and area. While increasing the number of these types of jobs may not be the ultimate policy goal, they could play an important role as a stepping-stone into full-time and permanent jobs for several workers that lack labor market opportunities.

**Outdated labor laws and rigid labor market regulations hurt job opportunities and may do so disproportionately for women and youth.** Compared to other countries in the region, El Salvador has very strict regulations in terms of flexible employment. Several factors contribute to this rigidity (Figure 49). First, the hourly minimum wage can be paid proportionately to the hours of work only if the person works less than 5 hours per day. If the individual works more than 5 hours but less than 8 hours per day, the employer should pay at least the 8-hour minimum wage (*Codigo Laboral, Articulo 147*). This is a disincentive to hire or formalize workers on a part-time basis. Second, there are important restrictions to the number of daily hours worked per week. Daily working hours (from 6:00 a.m. to 7:00 p.m.) cannot exceed 44 hours per week. Any hour beyond that threshold should be paid an additional premium equivalent to 100 percent the level of the regular wage. Third, night working hours have a wage premium that could hurt businesses with continuous production processes. Night working hours cannot exceed 7 hours per day or 39 hours a week. This means that the extra-hours threshold kicks in earlier than for daily hours. Moreover, they are paid at a rate 25 percent higher than those paid during daily hours. If a person works 8 hours per day and four of those hours are at night, the whole 8 hours should be paid as nighttime work. Fourth, some changes in working hours require additional bureaucratic procedures. For example, a regular week schedule could be split up in three parts, each no longer than 12 hours. But this requires the authorization of the National Director of Labor (*Director General de Trabajo*). Finally, it is not allowed to provide a compensation (whether in cash or in kind) for workers who do not wish to use their vacations and to divide or accumulate vacation periods.

The tax wedge—the difference between the wages paid by the employer and the take-home pay—in El Salvador is high relative to other countries and to the benefits it entails. A high level of the tax wedge can create disincentives to look for a job, and it can depress the demand for labor by increasing labor costs. These distortions can be exacerbated when the benefits (real or perceived) associated with social security contributions are poor. This could be the case in El Salvador, where the tax wedge is the second highest among comparator countries, only surpassed by Costa Rica (Figure 50, panel (b)). The tax wedge includes social security contributions (10.5 percent), mandatory contributions to private sector pension institutions (15 percent), and the income tax (0–30 percent based on income thresholds). Countries with similar levels of the tax wedge include higher-income economies such as Chile, Switzerland, and Japan. In contrast to most countries where the tax wedge tends to be progressive—because the income tax rate tends to increase with income levels—it is not clearly the case in
El Salvador. On the one hand, the fact that low earners are exempted from the income tax contributes to the progressivity of this instrument. On the other hand, the fact that monthly earnings of US$2,038.11 or more are subject to the same terms of tax deduction regardless of the level makes the instrument more regressive. For example, a person earning US$2,100 will pay more taxes as a share of his or her earnings than a person whose wage is US$4,000 or US$6,000, since all three wages fall within the same threshold or scale. A high level of the tax wedge may damage the job opportunities of groups with weaker labor market attachment, such as women and youth, as it requires employers to make an additional commitment for employees whose productivity is more uncertain to them.
What accounts for gender and youth gaps in entrepreneurship?

The higher incidence of informality among youth and women may not only reflect higher barriers to formal salaried jobs among these groups but also obstacles to register their businesses. The higher incidence of informality among women and youth is also present among small-firm owners. When comparing firms with similar characteristics, women owners are 10 percentage points less likely to have their firms registered with the tax authority than men owners and 3 percentage points less likely to make social security contributions on behalf of their employees (Figure 51). Accordingly, a 20-year-old owner is 3–4 percentage points less likely to have formalized his or her firm and workers than his or her 40-year-old counterpart. The higher incidence of informality among women and youth is largely driven by the type of firms they relate to. In particular, among salaried workers, they are more likely to work for a small firm than other workers.

Women and youth lead lower-productivity businesses than the average firm owner. Informality is many times a reflection of low productivity (see Chapter 2), that is, firms have to reach a minimum productivity threshold to be able to afford the fees and additional expenses associated with tax and social security registrations. This channel may be relevant, particularly for young entrepreneurs, since they tend to own firms of lower productivity. When comparing the labor productivity of businesses with otherwise similar characteristics, the role of the owner’s age becomes weaker, but it does not disappear (Figure 52). Other important factors

Source: Based on CONAMYPE 2017.

Note: Blue bars indicate the gap with respect to men. Orange bars indicate the gap with respect to entrepreneurs ages 30 years or more.
that contribute to account for the lower productivity of female-owned businesses is that they tend to have lower levels of education and they are less likely to use digital technologies. In contrast, young entrepreneurs fare better in terms of educational attainment and ICT use, which tends to mitigate their productivity gap with older firm owners. However, the fact that they are more likely to have firms in low-productivity services tends to widen the age gap in labor productivity.

Do remittances contribute to the high inactivity rates of women and youth?

El Salvador is one of the countries with the largest remittance inflows in the world. In 2018, they represented almost 21 percent of GDP (WDI 2019). Only five other economies had a higher ratio of remittances to GDP. While remittances can have important economic benefits—such as increased income support for migrant-sending households—they can also depress labor supply. This is because they may raise the reservation wage of individuals living in receiving households.

The evidence suggests that remittances may have some negative effects on labor force participation in El Salvador. While identifying the causal effect of remittances is challenging, evidence from household surveys show that women living in households that receive remittances are 13 percentage points less likely to look for a job (Sousa and García-Suaza 2018). This link between remittances and inactivity seems stronger among unskilled women (Fajnzylber and Lopez 2008). It is important to mention that these estimates should be interpreted with caution, since the relationship could also be partially explained by the fact that households with poorer labor market outcomes—including inactivity—may be more likely to send a family member abroad.

Raising opportunities for women and youth in El Salvador

In summary, women and youth in El Salvador not only have worse employment outcomes than the average worker but also the gaps have been on the rise. Large fractions of young people—mostly women—are not accumulating human capital on the job or in school, a factor that would contribute to perpetuate gender gaps throughout the life cycle. Social norms regarding the role of women as the main caregivers contribute to the labor market exclusion. However, labor laws and regulations also play a role by lowering their chances of finding a formal flexible job that could be their stepping-stone into the labor market. The digital gap between female and male entrepreneurs also helps explain the different levels of productivity and formality of their businesses. Leveling the playing field for all workers and entrepreneurs is a necessary step to reduce gaps in labor market outcomes.
4. POLICY IMPLICATIONS

The first three chapters of this report show that the main challenges of the Salvadoran labor market are (a) lack of capacity of the private sector to create the number of jobs needed for current and especially for future entrants in the labor force, (b) poor quality of jobs, and (c) low integration of women and youth into the labor market. While these challenges are by no means exclusive to El Salvador, the analysis of the report contributed to identify specific bottlenecks affecting the economy along these dimensions. This section outlines a set of policy recommendations that can contribute to make progress along these lines.

This report shows that the impacts of crime and violence on job creation and the quality of jobs are pervasive in El Salvador. A crime shock is fatal for small firms, and it is very costly for medium and large ones. This, at the same time, creates weak incentives to grow, formalize, and gain visibility. Policies to reduce the incidence of violent crimes are beyond the scope of this report. However, as mentioned throughout the report, the link between crime and poor labor market outcomes goes both ways. In other words, while reducing crime is a necessary condition to spur job creation, it is not a sufficient one. At the same time, when labor opportunities improve—especially for vulnerable youth—crime rates may decline by reducing the incentives to carry out criminal activities. Evidence for the United States shows that improving the labor market outcomes—particularly the unemployment rate and wage levels—of unskilled young men has a significant impact on crime reduction (Gould, Weinberg, and Mustard, 2002). However, a sustained long-term decline in crime depends on whether the wage levels of this group exhibit sustained long-term gains as well. Thereby, to improve labor market outcomes and reduce crime rates, both economic and crime-related policies are needed. The next paragraphs outline recommendations for the former, organized in two pillars: (a) improving the business environment to increase economic dynamism and (b) reducing distortions in the allocation of labor.

4.1 IMPROVING THE BUSINESS ENVIRONMENT TO INCREASE ECONOMIC DYNAMISM

Streamlining the process to obtain permits and licenses

The process for firms to obtain permits and licenses is time-consuming and expensive, particularly for small formal firms trying to expand. The number of days of work that are needed to fulfill the requirements of starting a formal business is almost 15 times that of the country with the best practice, being equivalent to about 45 percent of GDP per capita. At the same time, burdensome procedures to close a business could be a deterrent to open one. In El Salvador, it takes 3.5 years to close a business compared to 1.7 years in high-income countries.

Lack of coordination and disperse procedures for business registration and starting a business further constrain dynamism in the private sector of El Salvador. Qualitative surveys suggest that entrepreneurs and firms struggle with an excessive number of procedures, which do not necessarily follow a single standard for their application, leading to regulatory unpredictability for investors and entrepreneurs. Furthermore, the burden of moving between ministries or agencies for business registration and obtaining licenses and permits relies on the entrepreneur or investor. Lack of proper coordination between government entities adds a layer of complexity to this process.

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There are positive experiences from other countries in the region, such as Mexico, regarding the implementation of reforms to improve the efficiency of opening and expanding businesses. Mexico's Federal Commission for Improving Regulation (COFEMER) introduced a reform in 2002 that reduced the number of days required to register a business from 30.1 to 1.4. The reform also created one-stop-shops (OSSs) in Mexico's most populous cities to implement the accelerated registration system. The reform increased the number of registered businesses by 5 percent (Bruhn 2011). This type of reforms had mixed success in other countries such as Peru (Mullainathan and Schnabl 2010), and these reforms may not be as successful in less populous and more rural areas (Bruhn and McKenzie 2014), since the latter may need a different type of intervention given their different capabilities and goals. Despite these moderate effects on firm creation, simplifying and reducing the costs of the processes to open and expand a business represent a reduction in operating costs for firms with incentives to become and stay formal.

OSSs under the integrated registration function and the online registry models have proven highly effective in other countries, such as Azerbaijan. Azerbaijan was ranked as top reformer in Doing Business 2009 after introducing an OSS, which created a single database in which the functions of all involved agencies were integrated, thus reducing time, cost, and the administrative burden on the business. The cost, time, and number of steps to start a business were halved. As a result, business registration increased by 40 percent in its first six months of operation (World Bank Group 2009). Key implementation steps to setting up the OSS in Azerbaijan that could be adapted to the Salvadoran context included

(a) Identifying one institution, with existing capacity to build on, as the administrative body responsible for the OSS;
(b) Creating a working group to review laws and procedures and propose practical amendments in the short-term, including adjustments to complementary laws such as access to credit and social insurance;
(c) Adopting ICT through the enhancement of an online platform building on an existing database with the potential to become a unified business registry; and
(d) Creating a unified form for registration to reduce duplication in submitting the same information separately to different government entities.

According to international experience, three aspects are key to successful results of the OSS: coordination, transparency, and predictable service delivery. In terms of coordination, the mandate should come from the top to align ministries and agencies. With respect to transparency, a grievance mechanism should be established to receive feedback on service delivery performance. Service delivery predictability is achieved through standard procedures to ensure quality of the services, fully trained personnel to administer those procedures, and an effective communications strategy.

El Salvador is committed to working on reforms to improve business registration and procedures to start a business to increase economic dynamism. Some key forward-looking steps have taken place in this direction. In February 2018, the Law of Administrative Procedures became effective. This law aims at establishing more effective and relevant regulatory framework of the public administration procedures to simplify administrative procedures. Moreover, in January 2019, the Law of Regulatory Improvement was approved by the General Assembly and aims to improve the quality of the cost/benefit of the public administration regulations. It also eliminates unnecessary requirements that negatively affect the business climate, competitiveness, and foreign trade and investment. During 2019, the government, with the support of the Institute of Regulatory Improvement (OMR for its acronym in Spanish), was carrying out an exhaustive review of the regulatory framework and procedures required to register businesses and start business operations. This review is aimed at reducing and optimizing procedures led by a working group. A second study by the World Bank will look further into related business environment constraints.
BOX 3. PROTECTING WORKERS DURING COVID-19

According to World Bank (2020), the COVID-19 crisis may push 40–60 million people into extreme poverty around the world. While Sub-Saharan Africa might be the hardest-hit region, the impacts will be significant in Latin America and the Caribbean as well, since 2.7 million people may fall into extreme poverty in the region. This crisis may also exacerbate existing inequalities in the labor market, as workers who are able to telework and keep their jobs are more likely to have better jobs to begin with. As seen in Figure 53, college graduates and workers with a salaried job in the formal sector are those with jobs more amenable to teleworking in El Salvador. This is because less-educated workers in the informal sector have jobs more intensive in physical tasks that often require working outdoors or at a specific location. In addition, they are less likely to use ICT at work or to have an internet connection at home. The rest of this box summarizes some of the policy responses that countries around the world are implementing to protect workers.

Social assistance has been adapted to COVID-19 response in three ways. This includes expanding coverage, increasing benefits, and making administrative requirements simpler and more user friendly. Specifically, administrative adaptations are occurring in 42 countries, for example, anticipation of payments that are due at a later date (for example, Malaysia), flexibility in the time of collection (for example, Algeria), home delivery of cash for seniors (for example, Armenia), postponement of recertification (for example, Georgia), waiving of conditionalities (for example, the Philippines), and sharing of delivery systems across programs (for example, Jordan). Increases in benefits among preexisting programs are implemented in 46 countries, including transfer value being increased (for example, Egypt) and additional payment cycles (for example, Chile). Coverage extension is under way in 159 countries: this includes expanding coverage of existing programs (22 cases) and 391 new social assistance programs (6 of which are universal). Combined, those adaptations across administration, generosity, and coverage in social assistance benefit over 1.7 billion individuals. The same estimate applied only to cash transfers lead to an estimated 1.1 billion people benefiting from such adaptations. If we only consider coverage (horizontal expansion) of new and existing cash transfer schemes, these cover an estimated 914 million people.
Emergency and temporary cash transfers are being made to informal workers, mainly through a household approach. An innovative new program to respond to COVID-19 and targeting informal workers, Ingreso Solidario, utilizes recent regulatory modernization supportive of digital financial services to offer the transfer through bank accounts and mobile wallets. As of May 12, 2020, Colombian authorities have been able to reach 1.6 million families through more than 20 financial institutions with the Ingreso Solidario program. Other countries are also targeting cash transfers to support informal workers including Argentina, Jordan, Brazil, Burkina Faso, Cabo Verde, Chile, Ecuador, Egypt, El Salvador, Fiji, Georgia, and the Philippines, among others.

Regions are scaling up cash transfers at different levels and pace. Asia is a region with the highest absolute number of beneficiaries of cash transfers coverage, including East Asia and the Pacific Region [first] and South Asia Region [second]. The lowest number is registered in Sub-Saharan Africa. In terms of the share of the population covered, North America is the highest [22 percent of the population], while only 2 percent of Sub-Saharan Africa’s population is covered by planned or actual cash transfers reported for COVID-19.

In terms of social insurance, there has been a remarkable uptick in measures recently—now including 254 measures in 124 countries. Among the most popular interventions, unemployment benefits include 77 measures, now higher (for the first time since measures were tracked) than social security contributions having been waived or subsidized [61 programs]. These are followed by 55 paid sick leave measures in 47 countries.

The number of labor market interventions includes 126 measures in 79 countries. Wage subsidies continue to dominate those interventions. Activation measures and labor market regulation adjustments are present in 16 and 21 countries, respectively. Shorter-time work arrangements are adopted in 9 countries.

Authorities around the world are promoting the use of digital payments to conform with social distancing measures. To prevent crowding around cash-out points [for example, ATMs, bank’s branches, and non-bank agents] which could increase health risks for the population, authorities are working with stakeholders to provide incentives for the immediate adoption and use of digital payments. Policy responses for a wider adoption of digital payments include enabling easier opening of accounts for individuals, onboarding of agents and merchants, and enabling increases in transaction limits and fee waivers for digital payments transactions.

Several countries have leveraged/deployed digital payments to deliver emergency Government-to-Person (G2P) programs. The nature and scope of deployment of digital payments for G2P emergency programs depend on the level of development of the digital payment ecosystem and financial inclusion in the country. Countries with robust digital payments ecosystem and high levels of financial inclusion among recipients were able to quickly deploy digital cash transfers. For example, in India, 200 million account holders of the Pradhan Mantri Jan Dhan Yojana program, a financial inclusion program, were able to receive account-based cash transfers as an immediate response to the COVID-19 pandemic. Thailand used the PromptPay system to deliver digital cash transfers. In contrast, in other countries, with low levels of financial inclusion and development of the digital payments ecosystem, authorities have found themselves bound to either hand out cash directly to beneficiaries [the Philippines] or exclusively use cash-out points to deliver social assistance payments [Ecuador]. Countries with relatively well-developed payments ecosystem, such as Colombia, deployed digital cash transfers in different phases as authorities and stakeholders reinforced their social registries and payments mechanisms. In some cases, authorities have deployed non-account-based options that leverage digital payment channels. For example, the emergency program for informal workers in Peru uses one-time-passwords, which are obtained through a cellphone application that can be used without opening an account, to withdraw money from branches, ATMs, and non-bank agents.

Social registries, databases, and online and mobile platforms have become essential to deliver digital G2P emergency payments. Many countries that deployed digital cash transfers have leveraged the information contained in the social registries or collected through online and mobile platforms. Usage of the information ranges from prefilling digital forms for account opening [Brazil] to providing beneficiaries’ contact information to authorities, so they can request them to open accounts [Jordan]. In this case, a successful implementation of digital cash transfers is also a direct function of the quality and completeness of the social registries, databases, and online and mobile platforms.
Improving the incentives and capacity of firms to formalize

Evidence for other developing countries suggests that formality offers very little benefits to firms (De Andrade, Bruhn, and McKenzie 2016; De Mel, McKenzie, and Woodruff 2013), which is consistent with the mild impacts of registration reforms on them. As highlighted throughout this report, informality and low productivity are part of a vicious cycle. Policies to improve productivity and to increase the incentives to formalize may help break it.

Improving productivity can increase the formalization of businesses by making it relatively more affordable for firms to comply. In the current scheme, it is basically unfeasible for small firms to formalize: those at the bottom of the sales distribution would have to give away 68–196 percent of their annual sales to pay for registration fees, taxes and tax services, and formalizing of a worker at the minimum wage.

Fostering ICT adoption can not only contribute to raise the productivity of firms in El Salvador but also foster the use of e-government services among firms and people to increase transparency and efficiency of service delivery (World Bank 2016). Internet use in El Salvador is very low when compared to countries in the region and at the same level of development. What is intriguing is that the cost of internet access is at similar levels—relative to GDP—to that of Latin America (World Bank 2016). It is consistent, though, with the finding that the demand for skills that complement digital technologies is declining, while the demand for routine workers—who are substitutes with ICT—is increasing. While the lack of skills to use these technologies could be a barrier for adoption—please see more on this in the following paragraphs—weak competitive pressures could also play a role (Saraf 2017).

Fostering financial inclusion of MSMEs can support formalization and growth of businesses. As mentioned previously, access to finance is not a strong incentive for firms with 50 employees or less to become formal in El Salvador. Moreover, financing options for small firms are limited in El Salvador, and most firms that claim to have obtained credit (63 percent) did so through other channels that have weaker requirements, such as cooperative banks, individuals, and family members. In economies where MSMEs (formal and informal) are underserved by the financial sector, credit guarantee schemes (CGSs), along with other measures, have proven effective in increasing credit access for MSMEs. CGSs are a common form of government intervention in MSME credit markets, which have helped reduce risk of loans to MSMEs, especially for those businesses which lack collateral. For example, in Morocco, the Caisse Centrale de Garantie (CCG), the administrator agency of guarantees, designed different CSG products for the MSME sector, including the guarantee for very small enterprises (VSEs). This guarantee had a simplified qualifying criterion adapted to reach the niche market and supported the banking sector by enhancing its capabilities to address this sector. Through the implementation of CSG products, the number and volume of loans to the MSMEs are estimated to have increased by 88 percent and 18 percent, respectively, since the end of 2011. In 2017, the average loan size for MSMEs was approximately US$22,000. These results were also driven by complementary efforts carried out by the government, which included changes to the regulatory framework, introduction of incentives for borrowers to formalize and access credit, and improvements to financial infrastructure. To incentivize the participation of MSMEs, a simplified taxation system, adapted social contributions, and extended social security coverage were set in place. Moreover, major incentives for the VSE sub-sector, including the reduction of the corporate profit tax and some tax incentives for individual VSEs opting to transform into a corporation, were introduced. In terms of infrastructure, a credit bureau was established and information sharing between banks on borrowers was facilitated, which helps prevent over-indebtedness of borrowers and increase the management capabilities of MSMEs and that of the banks to administer loans for VSEs. The CCG is currently developing a product for the microfinance sector, which will further contribute to poverty reduction.

Current challenges, such as low financial inclusion and low access to credit, imply that El Salvador needs to consider policy changes aimed at enabling the environment to enhance financial inclusion,

33 The VSE segment constitutes both formal and informal enterprises, employing 5–49 employees. VSE loans are loans that range from US$10,000 to US$50,000. Serving the Very Small Enterprise [VSE] Segment by Microfinance Institutions in the Arab World, International Finance Corporation (IFC) and Sanabel, August 2016.

34 Implementation Completion and Results Report, MSME Development Project No. 129326, June 7, 2018. World Bank.
particularly of the underserved sectors. There are different ongoing initiatives aimed at enhancing financial inclusion, but they are not yet coordinated, which could result in higher efficiency and impacts of the different efforts. Nevertheless, there are ongoing discussions with the government on formulating a financial inclusion policy with the support of the World Bank. The government has recognized the importance of enhancing access to credit for the MSMEs, with stronger support to the micro and small enterprises (MSEs). However, to improve access to credit, some key policy considerations would be needed. These considerations include enhancing the regulatory framework and supervision of the financial sector, improving financial infrastructure including digital services, diversifying financial products to address the credit needs of risky sectors, and improving coordination between the private and public sectors. In this direction, some key conditions that could contribute to enhancing access to credit include the introduction of a regulatory framework for microcredit to ensure proper risk management and the granting of unsecured loans, facilitation of registration of MSEs, and incentivization of formalization through tax regime reforms. Moreover, introduction of cost-efficient use of electronic signatures, with clear guidelines on use by the industry and with judiciary power to ensure the validity of the transactions, would improve the use of digital financial services. Currently, the information agencies and the central risk office of the Financial Services Regulator produce fragmented information of the Salvadoran market. Thus, facilitating information sharing within the sector would be fundamental to reducing the costs of credits and better analyzing the risks of potential clients. A follow-up study of the World Bank aimed at supporting the development of MSMEs will produce further recommendations that could include developing a new or expanded risk-sharing facility and improving secured transactions.

Professionalizing inspections services could help formalization, without hurting job creation. In El Salvador, larger firms are more likely to be inspected and to receive a higher number of inspections than smaller firms. This creates incentives for firms to stay in the shadows. Lessons from other economies show the importance of training inspection staff to also support firms that lack the capacity to comply with complicated regulations. Making the inspectors more accountable, increasing the transparency of the inspections (by establishing time limit to the visits and writing a summary of the visits), and randomizing the assignment of inspectors to firms can help improve compliance (Cojocaru 2017). For example, since 2001, many inspectorates in Georgia cannot inspect the same business twice in the same year for the same licenses and permits (Cordova-Novion and Sahovic 2010). Consolidating and coordinating different inspection agencies (tax, labor, food safety, and so on) can help distribute the burden of inspections across firms. In Albania, a number of inspectorates were merged from 33 to 15, and a Central Inspectorate was created to coordinate the work of inspectors (Cojocaru 2017). Relying on an objective risk-based inspection system rather than on ad hoc procedures can help bring more transparency to the system. For example, Latvia introduced a system to prepare an annual list of routine inspections based on priorities devised from risk management techniques. The system includes a mechanism for rating the inspected bodies to promote self-improvement (Cordova-Novion and Sahovic 2010).

4.2 REDUCING DISTORTIONS IN THE ALLOCATION OF LABOR

This report identified several distortions that affect the efficient allocation of the country's most abundant resource, its people. These distortions artificially inflate the price of labor, which makes it difficult for firms to hire workers, or at least to hire them formally. The following points describe some policy suggestions to reduce these distortions:

(a) Adapt the labor code to the ‘jobs of the new economy’. Stringent labor regulations are associated with smaller technology sectors and lower entry and exit of firms (World Bank 2019). These regulations were often based on countries with large industrial sectors where formality was the norm. In contrast, in countries where most workers are informal, they fail to protect most workers—particularly the most vulnerable. As shown in Chapter 3, labor regulations in El Salvador are very rigid, even for Latin American standards. Table 2 shows some recommendations on how to make the labor code more adjusted to these flexible jobs. It is important to emphasize that while more flexible regulations may

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35 Jobs of the new economy refer to jobs intensive in tasks that complement new technologies (such as non-routine cognitive and manual), demanding abilities such as creativity and critical thinking (analytical) and teamwork (interpersonal).
contribute to creating jobs; these reforms should be accompanied by strong social protection systems to protect workers. As this report was being finalized, progress was being made in the reform proposals to the labor code, but no final proposal was decided.

Table 2
Labor regulations—status-quo and recommendations

<table>
<thead>
<tr>
<th>Status quo</th>
<th>Recommendations</th>
</tr>
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<tbody>
<tr>
<td>Temporary contracts exist de facto in practice, but the law does not contemplate them.</td>
<td>Instead of focusing on types of contracts, it is more important to work on setting a set of standards and protections that apply to all contracts. A uniform set of protections could be defined in a way that is neutral with respect to the duration of the contract and that does not create incentives to avoid open-ended contracts. For instance, contributions to actuarially fair segments of social insurance plans should be part of all contracts regardless of their duration. If dismissal procedures are simplified, as discussed earlier, this should be possible. If contracts are treated differently by their duration, this will exacerbate the exclusion of vulnerable groups from longer contracts and thereby the duality of the labor market (Source: “Protecting All. Risk-Sharing for a Diverse and Diversifying World of Work.” A White Paper from the Social Protection and Jobs Global Practice. 2019).</td>
</tr>
<tr>
<td>Remote work/telecommute. De jure the law does not consider them.</td>
<td>If the employee works more than 5 hours per day, the employer must pay at least 8 hours at the hourly minimum wage (even if the person works less than 8 hours per day). Salaries should be proportional to the number of worked hours.</td>
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<tr>
<td></td>
<td>The work week during regular hours is 44 hours. If the employee works more than 44 hours per week, he/she should be paid a 100% wage premium for every extra hour worked. The wage premium for extra worked hours is considerably higher than that of other countries. For example, it is 25% in Mexico and 50% in Panama.</td>
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<tr>
<td></td>
<td>Night work cannot exceed 7 hours per day or 39 hours a week. The wage premium is 25%. The wage premium for night work is considerably higher than that of other countries. For instance, there is no premium for night work in Costa Rica and Mexico.</td>
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<tr>
<td></td>
<td>If a person works 8 hours a day and at least 4 hours are at night, the full 8 hours are paid at the night rate. Daytime work should not be considered night work.</td>
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<tr>
<td></td>
<td>Some changes in the work week for an employee require additional bureaucratic procedures, such as the approval of the National Director of Labor (Director Nacional de Trabajo). The adjustment process should be more flexible and efficient.</td>
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</tbody>
</table>

(b) Minimize the unintended negative effects of the Law to Incentivize the Creation of the First Job for Youth (Ley del Primer Empleo). The law seeks to further regulate and promote the creation of first-time jobs for a specific segment of population being youth ages 18–29 years, as a means to provide employment experience that can help them join the labor market. However, by competing with the apprenticeship regulations in the labor code, it creates inconsistencies and adds bureaucracy. For example, when compared to the latter, this law makes it harder for firms to register their employees, excludes informal firms, and increases the risk of inspections, among other issues. On the other hand, this law provides some tax incentives for firms.36 Two policy recommendations emerge. First, it is crucial to evaluate the impacts of this law on job creation for youth. Improving our understanding about which elements of this law helped foster youth employment will be key for the design of future programs with the same goal. Second, it is important to eliminate the inconsistencies between this law and those of the labor code.

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36 The Law to Incentivize the Creation of the First Job for Youth, Article 21, specifies that firms will enjoy income tax exemption at the end of the fiscal years as follows: (a) firms hiring 2–8 young people will have an income tax deduction equivalent to one annual minimum wage, (b) firms hiring 9–16 young people will have an income tax deduction equivalent to two annual minimum wages, and (c) firms hiring more than 16 young people will have an income tax deduction equivalent to three annual minimum wages.
(c) **Future increases in the minimum wage should be consistent with labor productivity growth.** The role of minimum wages as a policy tool to protect workers with low earnings is weak in a country where most workers are in the informal sector. The ratio of the minimum wage to value added—a common metric used to understand the role of minimum wages in competitiveness—is 0.5 in El Salvador. This level is higher than the world's average of 0.38. It is also higher than that of several Latin American economies such as Mexico, Panama, the Dominican Republic, Peru, Costa Rica, Colombia, Chile, and Uruguay, where the ratio lies between 0.1 and 0.4 (data source: Doing Business 2019). At their current level, they may contribute to the segmented nature of the Salvadoran labor market, where formal workers are in more productive sectors that pay higher wages while most informal workers earn wages below the minimum wage level. Future increases in the minimum wage should be transparent and consider the fact that they may hurt the workers who need more protection, by excluding them from the private sector.

(d) **The tax wedge should be consistent with the expected benefits.** The level of the tax wedge (the difference between take-home pay and labor costs) in El Salvador is relatively high for the benefits it is associated with. In addition to issues of myopia that may affect people’s valuation of future benefits such as pensions, it is important to make sure that the quality of the health services provided by the social security system is consistent with the cost imposed on workers and firms, to create incentives to contribute. Finally, unlike other countries such as Chile, the system does not include unemployment insurance. While including such a benefit may have serious budget implications, under the current framework, Salvadorans pay the same share of tax as Chileans for a lower-quality expected level of services.

(e) **Reducing labor market mismatches.** New labor market entrants seem to be at a disadvantage when they face the challenge of finding a job in a context where employers seem to place a greater value on experience than on educational attainment affecting women and youth labor participation rate. Against this backdrop, the following recommendations could help ease these challenges:

(i) **Start early and prevent school dropouts, particularly at the secondary level, to facilitate the school-to-work transition for youth and girls.** While there has been improvement in educational attainment in El Salvador, school dropout remains a challenge. The overall dropout rate in secondary education has increased from 30 percent to 39 percent (2000–2014) (Adelman and Szkely 2016), with a higher dropout rate in upper secondary level. According to the EHPM 2017, the main reasons behind school absences of youth ages 16–18 years include lack of interest and the need to work (36.2 percent), high costs (39.0 percent), domestic household chores and related household causes (11.7 percent), and other (13.8 percent). An important factor affecting school enrollment and attendance may be teen pregnancy, in which 19,190 girls ages 10–19 years became pregnant in 2017.37 Within this context, conditional cash transfers (CCTs) have been effective mostly in increasing student enrollment and retention (Baird et al. 2014; Bastagli et al. 2016) and reducing the direct and indirect financial barriers to education leading students to graduate from secondary school. For example, in Colombia, a widely known CCT program—Familias en Acción—increased enrolment quite substantially for children in secondary school age in rural areas (Attanasio et al. 2010), years of education, and the probability of graduating from secondary school (Garcia et al. 2012). Moreover, interventions that provide information to students on the benefits of education have had positive outcomes, such as in the case of the Dominican Republic (Jensen 2010). Furthermore, school-based teen pregnancy prevention programs have played an important role in preventing dropout, especially for girls (Azevedo et al. 2012).

(ii) **Improve quality and relevance of education, at secondary and tertiary education levels, to facilitate the school-to-work transition.**78 Attaining higher quality and relevance of education for the labor market could likely contribute to reducing future labor market mismatches in addition to improving school retention and improving learning outcomes. This would require a revision of

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38 These education levels are regulated by MINEDUCYT.
curricula to increase their relevance to the labor market demands, in particular, the skills of the jobs of the new economy and in connection with the productive sectors and the revision of quality standards. Moreover, it would require strengthening the capacity of teachers through training to deliver teaching in accordance with updated curriculum and quality standards, investing in adequate infrastructure, and conducting evaluation and measurement of education outcomes.

(iii) **Enhance the capabilities of the Technical and Vocational Education and Training (TVET) system**, in particular to meet the demands of the ‘jobs of new economy’ in the short term. The Salvadoran Institute for Professional Training (Instituto Salvadoreño de Formación Profesional, INSAFORP) is responsible for directing and coordinating the Vocational and Professional Training (VET) system, (technical is regulated by the Ministry of Education, Science and Technology [MINEDUCYT for its acronym in Spanish]) as mentioned earlier. In 2018, about 290 training accredited centers were affiliated with INSAFORP and provided a wide offering of trainings, including some aimed at vulnerable youth and women. Currently, according to the qualitative analysis included in this report, the most pressing skill demands seem to be related with the skills of jobs of the new economy, such as creativity and critical thinking (analytical), teamwork (interpersonal), or non-repetitive manual tasks. Brief rapid consultations were carried out with different stakeholders of the VET system, and key areas for further development were identified, particularly related to meeting with the demand of these new skills. These areas include (1) enhancing governance, (2) strengthening quality assurance and relevance of the curriculum, and (3) monitoring and evaluation.

**Enhancing governance.** During mid-year 2019, with the support of FOMILENIO II, significant efforts were made including the creation of a Coordination Council of TVET system. It was created as a permanent structure to foster dialogue and articulate efforts between MINEDUCYT and the productive sectors for decision-making on demand-based training proposals. In addition, about eight sectoral committees have been created for identifying the challenges, demands, and proposals on technical and vocational trainings for decision of the said council. The council is key to continue growing the relationship and active participation of the private sector and awareness of the employer on the benefits of training on labor productivity as this will ensure the continuity of these structures.

**Quality and assurance standards.** Enhancing quality and assurance standards requires that some key actions take place: strengthening and updating the training curricula, particularly in the sectors related to the skills of the new economy by bringing in the private sector very intentionally, formally, and systematically to advise the education authorities on the skills they seek, for instance, through the support of the sectoral committees; enhancing the certification system for such sectors to certify the skills and abilities acquired not only during training but also on the job through further developing the capacity of its certifiers and trainers and counting on the support of the private sector to validate the acquired skills; and implementing a system for monitoring and continuous improvement including following up with employers to receive feedback on the relevance of training and its application at work and measure training outcomes. It is recommended to carry out a rapid assessment on the readiness of the VET system to better satisfy a potential demand of skills of the new economy which will help further define an action plan to achieve a good level of readiness.

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39 Law of Professional Training, Decree No. 554, 1995, Article 3, defines professional training as any action or program, public or private, designed for training in occupations and techniques that provides or increases the knowledge, skills, and occupational practical skills necessary to perform productive work to support socioeconomic development and people’s dignity. The provisions of this law shall not apply to regular technical education programs authorized by the Minister of Education nor institutions of teaching such as universities, military, physical rehabilitation, arts, and sports.

40 INSAFORP is an autonomous institution, responsible for directing and coordinating the VET system. Its budget is funded at large by levies on the private sector and autonomous and decentralized institutions.

41 Eight sectoral committees have been created under the sectors of coffee, sugar, poultry, construction, plastic, tourism, MSMEs, and ICT.
In terms of obtaining validation of the private sector on the acquired skills and abilities, El Salvador is moving forward to gradually create a National Qualification Framework (NQF) with the support of FOMILENIO II. Lessons learned from the regional qualification framework—Caribbean Vocation Qualifications (CVQs)—suggest that positive outcomes can be achieved, especially when these qualifications are recognized and validated with the private employers and used by them. Since El Salvador is developing its NQF, it is recommended to implement pilots, in close coordination with the private sector and the TVET system to validate occupational standards for key productive sectors that have an ongoing certification system (for example, the plastic industry) to test the NQF before considering its scale-up.

(iv) Implement other programs to enhance youth employability, especially for the poor and vulnerable population. There has been extensive experience in the region on active labor market programs (ALMPs) seeking to connect youth to jobs to wage employment or self-employment. ALMPs include the following interventions: (1) short-term skills training, (2) entrepreneurship promotion, (3) employment services, and (4) subsidized employment interventions. In some contexts, interventions such as second chance education through flexible educational modalities are included. International experience has indicated that programs that integrate multiple interventions are more likely to lead to positive outcomes (Kluve et al. 2016). For instance, some studies of programs in Latin America and the Caribbean suggest that ‘Jóvenes’ Programs in Colombia, Panama, and the Dominican Republic raised employment by 0–16 percent for different programs and groups of participants, with higher impacts for women, younger participants, and residents of the capital city, and increased earnings by 0–22 percent (Gonzalez-Velosa, Ripani, and Shady 2012).

El Salvador has a strong track record in implementing employment and employability programs, albeit with some level of fragmentation, lack of inter-institutional coordination, and participation from the private sector. During the last decade, a myriad of programs have been implemented by public institutions with different coverage scales (varying from 2,000 to 100,000 beneficiaries) but with little coordination among programs. Against this backdrop, the current administration created a special structure in the Presidential House to facilitate coordination and allocation of resources to deter further fragmentation and duplication of efforts.

El Salvador has had relevant experiences of youth employment programs in recent years, including the implementation of programs such as Jóvenes con Todo and Bridges to Employment (expected to close in 2020), which were carried out following an integrated approach as mentioned previously. The implementation of these programs has helped reflect on the importance of key program aspects to further enhance results. First, experience denoted the need for a higher involvement of the private sector as partner and beneficiary of the programs to help identify the skills gaps to reduce labor mismatches and provide internship or apprenticeship opportunities for youth. Second, the implementation identified the importance of placing the right incentives to obtain the participation of the private sector, for instance, providing them with trained youth with relevant skills and well-developed socioemotional skills to better perform at work. Based on international experience, incentives such as wage subsidies, bonuses to the employee, or tax incentives have been used to increase work experience of youth and to reduce administrative costs of employers. Third, the implementation required the ability to coordinate multiple interventions to respond to various beneficiary needs and contexts.

(v) Enhance access to labor market information to reduce information asymmetries. Strengthen the Labor Market Observatory (LMO). The LMO needs to be strengthened through the development of an integrated information system (learning management information system [LMIS]) aimed at producing information to inform job seekers, students, education and training institutions, employers, investors, and policy makers on labor market trends to help

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42 NQF is an instrument which comprises the occupational standards—formally recognized—by the educational institutions and the employers against which the TVET is offered.
reduce information asymmetries. The current administration has a strong interest to strengthen the existing LMO currently housed in the Ministry of Labor and Social Welfare (MTPS for its Spanish acronym). The LMO is still in its early stages of development. Moving forward to further developing the information system, it is suggested to enhance its interoperability to integrate information from key databases including DIGESTYC publishing information of key economic and household surveys, Salvadoran Institute of Social Insurance (ISSS for its Spanish acronym) publishing information on employment trends of the formal sector, and conducting key systematic surveys to employers on the skills they demand. The interoperability of all these databases will enable the generation of integrated information on the labor market to better respond to the demands of its users. Furthermore, it is important to develop the capacity to generate analysis and engage the private sector as a user and producer of the information created.

Modernize the employment support services offices. MTPS has made significant strides in scaling up employment support services (currently with about 60 office desks nationwide); however, as part of the modernization agenda that the MTPS is pursuing, progressing on the interoperability of the LMO and these offices could aim to fully implement online services in areas where internet connectivity is high.

(f) Reduce the role of gender-biased social norms. This report shows that social norms regarding the role of women as the main caregivers are deep-rooted in El Salvador. Information interventions can help shape norms about women’s participation in the labor market. For example, Bernhardt et al. (2018) found that Indian women’s work outcomes were strongly associated with whether their husbands approved of them working outside the home. Lessons from other countries show that increasing the supply of day-care centers for children not yet in school can boost women’s labor force participation. For example, Canada implemented a “$5 a day” day-care program in 1997 for children ages 4 years or younger. This program increased labor force participation of married women by 7.7 percentage points (Baker, Gruber, and Milligan 2008). Evidence from the Caribbean, Latin American, and OECD countries suggests that access to subsidized childcare can have a significant positive impact on women’s employment rates and work hours (Mateo Díaz and Rodríguez Chamussy 2015). Argentina extended pre-school education to cover children of ages 3–5 years, which increased their mothers’ employment 6–16 percentage points (Berlinski and Galiani 2007). Guatemala City implemented a community-based day-care program for kids ages 7 years or younger, which increased their mothers’ wages by 30 percent, as well as the likelihood of having a formal job (Hallman et al. 2005). In Jordan, a private employer—a manufacturing factory—established an in-site childcare center; although still new, this initiative has already had a positive effect on productivity by reducing absenteeism and higher retention (IFC 2017).
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