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ECUADOR
CREATING FISCAL SPACE FOR POVERTY REDUCTION

A FISCAL MANAGEMENT AND PUBLIC EXPENDITURE REVIEW

Volume I

Main Text

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REPUBLIC OF ECUADOR – FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of 11/11/2004)

Currency Unit = US dollar

US$1.00 = US$1.00

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

AIDS	Acquired Immune Deficiency Symdrome
AIDIS/AEISA	*Asociación Interamericana de Ingeniería Sanitaria y Ambiental/Asociación Ecuatoriana de Ingeniería Sanitaria y Ambiental* (Pan-american Association of Environmental and Sanitary Engineering/Ecuadorian Association of Environmental and Sanitary Engineering)
ANDINATEL	*Empresa Andina Ecuatoriana de Telecomunicaciones* (Andean-Ecuadorian Telecommunications Company)
ANEEL	*Agencia Nacional de Energía Eléctrica* (National Agency of Electric Power)
APEID	Asia-Pacific Centre of Educational Innovation for Development
APRENDO	System of Academic Achievement Tests
BCE	Central Bank of Ecuador
BCG	Bacille Calmette Geurin Vaccine, Vaccination for Tuberculosis
BDH	*Bono de Desarrollo Humano* (Conditional Cash Transfer System)
BEDE	*Banco Ecuatoriano de Desarrollo* (Ecuadorian Development Bank)
CAE	*Corporación Aduanera Ecuatoriana* (Ecuadorian Customs Corporation)
CAF	*Corporación Andina de Fomento* (Andean Corporation of Promotion)
CATEG	*Corporación para la Administración Temporal Eléctrica de Guayaquil* (Corporation for the Temporary Electric Administration of Guayaquil)
CEDATOS	*Centro de Estudios y* Datos (Center of Studies and Data)
CEDEGE	*Centro de Desarrollo de la Cuenca del Guayas* (Center of Development for the Guayas Basin)
CELADE	*Centro Latinoamericano y Caribeño de Demografía* (Caribbean and Latin-American Center of Demography)
CEM	*Centros Educativos Matrices* (Educational Centers Headquarters)
CEMEIN	*Centro Estadal de Medicamentos e Insumos*
CENACE	*Corporación Centro Nacional de Control de Energía* (National Central corporation of Energy Control)
CEPAR	*Centro de Estudios de Población y Desarrollo Social* (Population Studies and Social Development Center)
CFAA	Country Financial and Accountability Assessment
CG	Central Government
CNRH	*Consejo de Recursos Hídricos* (Council of Water Resources)
CONAM	*Consejo Nacional de Modernización del Estado* (Council for Modernization of the State)
CONAMU	*Consejo Nacional de las Mujeres* (National Council of Women)
CONAREM	*Consejo Nacional de Remuneraciones* (National Council of Remunerations)
CONATEL	*Consejo Nacional de Telecomunicaciones* (National Telecommunications Council)
CONECEL	*Consorcio Ecuatoriano de Telecomunicaciones* (Ecuadorian Telecommunications Consortium)
CONELEC	*Consejo Nacional de Electricidad* (National Electicity Consortium)
CONTRATANET	government e-procurement portal
CPC	Credible Repayment Commitment
CPF	*Comité de Padres de Familia* (Family Parents Committee)
CPH	Cox Proportional Hazard (a Survival Model)
CREA	*Centro de Reconversión Económica del Azuay* (Center of Economic Reconversion of the Azuay)
CREG	*Comisión Reguladora de Energía y Gas* (Regulating Commission of Energy and Gas)
CTC	*Compañía de Teléfonos de Chile* (Chile Telephone Compay)
CTI	Technical Investments Commission
DFID	Department for International Development
DHS	Demographic Health Survey
DPT	Vaccination for Diphtheria, Pertussis and Tetanus
DSA	Debt Sustainability Analysis
EBFs	extra-budgetary funds
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
ECAPAG	*Empresa Cantonal de Agua Potable y Alcantarillado de Guayaquil* (Cantonal Business of Drinking Water and Sewer System of Guayaquil)
ECORAE	*Ecodesarrollo de la Región Amazónica Ecuatoriana* (Amazon Regional Eco-Development Tax)
ECV	*Encuesta de Condicionales de Vida*
EDAP	*Entidades Depositarias de Ahorro Previsional*
EMAAP-Q	*Empresa Metropolitana de Alcantarillado y Agua Potable – Quito* (Quito's Water Utility)
EMEDINHO	*Encuesta de Medición de Indicadores sobre la Niñez y los Hogares* (Special Module of Household Survey)
EMELEC	*Empresa Eléctrica del Ecuador* (Electric Company of Ecuador)
EMELGUR	*Empresa Eléctrica Regional Guayas Los Ríos, S.A.* (Regional Guayas-The Rivers Electric Company, Inc.)
EMs	Emerging Market Countries
ENDEMAIN	*Encuesta Demográfica y de Salud Materno Infantil* (Demographic Survey of Child-Maternal Health)
ENRE	*Ente Nacional Regulador de la Electricidad* (National Regulator Entity for the Electricity)
EPC	Engineering, Procurement, and Construction
EPS	*Empresas Prestadores de Servicios*
ETAPA	*Empresa Pública Municipal de Telecomunicaciones, Agua Potable, Alcantarillado (*Public Company for Telecommunications, Drinking Water, and Sewer System)
EUC	Education Unit Center
FASBASE	*Fortalecimiento y Ampliación de Servicios Básicos de Salud* (Strengthening and Expansion of Health Services)
FEIREP	*Fondo de Estabilización, Inversión Social y Productiva y Reducción de Endeudamiento* (Fund for Stabilization, Productive and Social Investment and Reduction of Indebtedness)
FEP	*Fondo de Estatización Petrolera* (Oil Stabilization Fund)
FISE	*Fondo de Inversión Social de Emergencia* (Emergency Social Investment Fund)

FODESEC	*Fondo de Desarrollo Seccional* (Fund for Sectional Development)
FONDETEL	*Fondo para el Desarrollo de la Telefonía Rural* (Telecommunications Development Fund)
FS	*Fondo de Solidaridad* (Solidarity Fund)
FTSRL	Law on Fiscal Transparency, Stabilization and Responsibility
GDP	Gross Domestic Product
GOE	Government of Ecuador
GTZ	German Technical Cooperation Agency
HDI	Human Development Index
HIPC(s)	Highly Indebted Poor Country (ies)
ICE	*Impuesto a los Consumos Especiales* (Special Consumption Tax)
IDB	Inter-American Development Bank
IEOS	*Instituto Ecuatoriano de Obras Sanitarias* (Ecuadorian Institute of Sanitary Works)
IESS	*Instituto Ecuatoriano de Seguridad Social* (Ecuadorian Social Security Institute)
IM	Infant Mortality
IMF	International Monetary Fund
INEC	(*El Instituto Nacional de Estadística y Censos* (Integrated System of Household Surveys)
INECEL	*Instituto Ecuatoriano de Electrificación* (Ecuadorian Power Authority)
INH	*Instituto Nacional de Higiene* (National Institute of Hygiene)
IPS	interbank payment system
IRS/SRI	Internal Revenue Service/Servicio de Rentas Internas
ISR	personal income tax
ISSFA	Military Social Security Institute
ISSPOL	*Instituto de Seguridad Social de la Policía Nacional* (Institute of Social Security of the National Police)
ITT	Oil Fields (*Ishipingo-Tambococha-Tiputini*)
ITU	International Telecommunications Union
IVM	Internal Value Measurement
JASS	*Juntas de Agua y Saneamiento* (Committee for Water and Disinfection)
LAC	Latin America and The Caribbean
LMG	*Ley de Maternidad Gratuita y Atención a la Infancia* (Law of Free Maternity and Attention to Infancy)
LNG	Liquefied Natural Gas
LOAFYC	*Ley Orgánica de Administración Financiera y Control* (Organic Law of Financial Management and Control)
LSMS	Living Standards Measurement Study
MBS/STFS	*Ministerio de Bienestar Social* (Ministry of Social Affairs)
MDGs	Millennium Development Goals
MED	Ministry of Education
MEF	*Ministerio de Economía y Finanzas* (Finance Ministry)
MEM	*Ministerio de Energía y Minas* (Ministry of Energy and Mines)
MIDUVI	*Ministerio de Desarrollo Urbano y Vivienda* (Ministry of Urban Development and Housing)
MNL	Multinomial Logit Model
MO	Mendoza-Oviedo
MPH	Ministry of Public Health
MYBF	Multiyear Budgeting Framework
NBI	*Necesidades Básicas Insatisfechas* (Unmet Basic Needs)
NFPS	Non Financial Public Sector
NWFP	North West Frontier Province
OECD	Organization for Economic Co-operation and Development
OLS	Ordinary Least Squares
ORDs	Regional Development Organizations
OSCIDI	*Oficina de Servicio Civil y Desarrollo Institucional* (Office of Civil Service and Institutional Development)
OSINERG	*Organismo Supervisor de la Inversión en Energía* (Supervising Agency for Energy Investment)
OTECEL	Bellsouth, *Empresa Telefónica*
PACIFICTEL	Pacific Telephone—Fixed line telecommunications operator in the coastal region
PAE	*Programa de Alimentación Escolar* (School Breakfast Program)
PAHO	Pan-American Health Organization
PAI	*Programa Ampliado de Inmunización en las Américas* (Immunization Program)
PANN	*Programa Nacional de Nutrición y Alimentación* (National Nutritional Program for Children)
PEM	Public Expenditure Management
PER	Public Expenditure Review
PGE	*Presupuesto General de Estado* (Central Government Budget)
PHRD	Public Human Resource Development
PPA	Power Purchasing Agreement
PPC	*Programación Periódica de Caja* (cash balance periodic programming)
PPS	Project for Public Spaces
PRADEC	*Programa de Asistencia y Desarrollo Comunitario* (programs of Aid and Common Development)
PRAGUAS	*Programa de Agua y Saneamiento para Comunidades Rurales y Pequeños Municipios* (Project Appraisal Document, Rural and Small Towns Water Supply and Sanitation Project)
PROBE	Public Report on Basic Education
PROMEC	*Proyecto de Modernización de los Sectores Eléctrico, Telecomunicaciones y Servicios Rurales* (Power and Communications Sectors Modernization and Rural Services Project)
PROST	Pension Reform Options Stimulation Toolkit – developed by the World Bank
PRS	Poverty Reduction Strategy
RER	Real Exchange Rate
RGP	Referential Generation Price
ROSC	Reports on the Observance of Standards and Codes
RUC	*Registro Único de Contribuyentes* (centralized taxpayers registry)
SAPYSB	*Subsecretaria de Agua Potable y Saneamiento Básico* (Undersecretary of Drinking Water and Basic Sanitation)
SELBEN	*Sistema de Identificación y Selección de Beneficiarios de los Programas Sociales* (Poverty Mapping and Strengthening Database)
SENATEL	*Secretaria Nacional de Telecomunicaciones* (National Telecommunications Office)
SENRES	*Secretaría Nacional Técnica de Desarrollo de Recursos Humanos y Remuneraciones del Sector Público* (National Technical Office of Human Resources Development and Remunerations of the Public Sector)
SIAN	Sistema Integrado de Alímentación y Nutrición
SIEH	*Sistema Integrado de Encuestas de Hogares* (Integrated Home Survey System)
SIGEF	*Sistema Integrado de Genercia Econónica y Financiera* (Integrated Financial Management System)
SIGOB	*Sistema de Gestión de Gobierno* (Government Management System)
SINEC	*Sistema Nacional de Estadísticas y Censos* (National System of Statistics and Censuses)
SNEM	*Servicio de Erradicación de Malaria* (Malaria Eradication Service)
SOTE	*Sistema de Oleoducto Transecuatoriano* (Trans-Ecuadorian Pipeline)
SPA	*Subsecretaria de Protección Ambiental* (Undersecretariat on Environmental Protection)
SPR	Strategic Policy Research
SSC	*Seguro Social Campesino* (rural social security)
SSO	*Seguro Social Obligatorio* (obligatory social security)
STFS	*Secretaria Técnica del Frente Social* (Technical Secretariat of the Social Front)
STFS-SIISE	*Sistema Integrado de Indicatores Sociales del Ecuador* (Integrated System of Social Indicators of the Social Cabinet)

SUPTEL	*Superintendencia de Telecomunicaciones* (Super-intendence of Telecommunications)
TELECSA	Ecuadorian Telecommunications—South America
UBN	Unsatisfied Basic Needs
UDENOR	*Unidad de Desarrollo del Norte* (Northern Development office)
UNDP	United Nations Development Programme
UNE	*Union Nacional de Educadores del Ecuador* (National Teacher's Union)
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations Children's Fund
VAT	Value-Added Tax
VOIP	Voice-over-IP
WFP	World Food Programme
WHO	World Health Organization

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Ecuador Public Expenditure Review—Volume I

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PREFACE

The last Public Expenditure Review for Ecuador (PER) was produced in 1993. More than a decade later, the purpose of this report is to provide the Ecuadorian authorities with the World Bank's and Inter-American Development Bank's joint comprehensive account of their diagnoses and recommendations in the area of fiscal management and public expenditure. As the Gutiérrez Administration moves forward in its second year in office, it is hoped that the content of this PER will be useful for Ecuador both to deal with the formidable fiscal challenges it faces and to take advantage of the existing opportunities in its development agenda.

This report consists of two volumes. Volume I examines whether, and how, the core goals of public expenditure management, i.e., balanced fiscal aggregates, resource allocations to strategic sectors, and equity and microeconomic efficiency of public spending are met in Ecuador. Volume II presents sector studies on fiscal sustainability, the fiscal rules, education, health, pensions, the results of a national teachers tracking survey, water and sanitation, electricity, telecommunications and oil.

The report does not provide full coverage of all areas affected by public expenditure. It focuses on the main themes that are critical for Ecuador's fiscal consolidation and poverty reduction following dollarization. In most cases, it does provide choices to key policy questions that are likely to occupy Ecuadorian policymakers over the remaining of the Government, like defining FEIREP proceedings, budget allocations, or social programs prioritization. Thus, it provides an independent analysis of the selected areas where both Banks are specially involved, and a set of possible recommendations to address them. This report reflects policy developments through May 31, 2004.

According to the Ecuadorian Authorities, the PER is "an important contribution from the World Bank and the Interamerican Development Bank to public policy. Volume I, in particular, correctly identifies fiscal vulnerabilities in the new context of dollarization, and proposes an adequate fiscal management that increases expenditure flexibility, develops budget management reform, increases public (social) investment, and brings transparency to public expenditure. All this is supported by an implicit proposal for a Fiscal Pact for Poverty Reduction. For its part, Volume II deals with sectoral policies, and their link to fiscal management. It identifies the most efficient and cost-effective interventions in the social sectors, while making an optimal use of the reduced and available fiscal space. The study also recognizes the importance of political constraints, and the difficulties of setting steady rules in a non-cooperative game among national political actors that are particularly reflected in budget allocations. It correctly emphasizes the need to bring full transparency of information on the management of public accounts among all domestic actors as starting point for sectoral reform. The report has a global view and suggests positive steps. Somehow, it should contribute to align fiscal and institutional policies in the social and basic infrastructure sectors, and to strengthen them in the context of the ongoing negotiations for a Free Trade Agreement with the US., while preserving difficult domestic equilibria on the development agenda."

ECUADOR: CREATING FISCAL SPACE FOR POVERTY REDUCTION

FISCAL MANAGEMENT AND PUBLIC EXPENDITURE REVIEW

EXECUTIVE SUMMARY

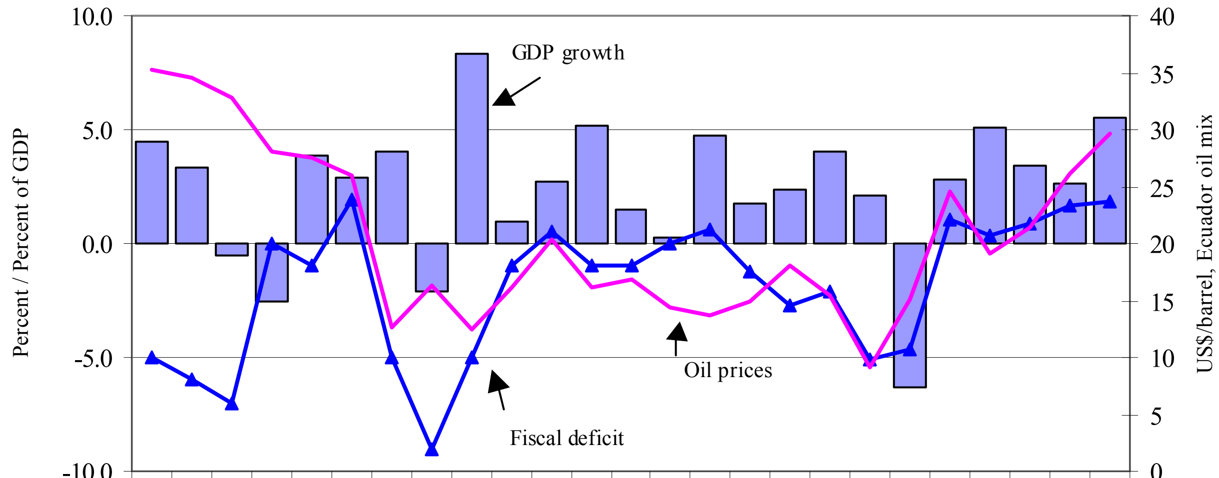
1. **Since Ecuador adopted full dollarization in early 2000, its fiscal performance has significantly improved.** The new exchange rate regime is underpinned by sound fiscal policies and structural reforms. Following a difficult transition, the Gutiérrez administration strengthened the dollarization framework with its Program of Economic Restructuring and Human Development. The results achieved thus far are encouraging: Ecuador is one of the best-performing economies in Latin America.

- Growth has resumed and is expected to reach above 5 percent in 2004.
- Inflation fell to single digits in late 2002 and is projected to continue declining below 3 percent in 2004.
- The Non Financial Public Sector (NFPS) primary and overall fiscal surpluses in 2003 are among the highest in the Latin American region (4.7 percent of GDP and 1.7 percent of GDP) and are projected to reach similar levels in 2004, reinforced by the new Fiscal Responsibility, Stabilization, and Transparency Law (FRSTL);
- The current account deficit has halved, most arrears were cleared and public indebtedness was lowered by about 5 percent of GDP in 2003. These outcomes are also projected to further improve in 2004.

2. **The Ecuadorian economy, however, remains vulnerable.** External factors, particularly oil prices, have a strong impact on the economy (Figure ES.1), as do shocks such as sudden stops of capital flows, rising interest rates, falling remittances or natural disasters. Shocks cause stress in the fiscal accounts, depreciate the real exchange rate, and threaten fiscal sustainability. The effect of these shocks could be augmented or alleviated by the Government's use of fiscal policy, which is the principal macro-economic policy tool available in a dollarized economy.

3. **Poverty reduction is critical to sustain the country's stability in the medium term**. As a result of the triple—banking, debt and exchange—crises of the late 1990s, poverty has increased. The national poverty rate increased from 40 to 45 percent between 1990 and 2001, and the number of poor increased from 3.5 million to 5.2 million, with a marked concentration of new poor in the urban areas. President Gutiérrez has committed to designing and implementing a Poverty Reduction Strategy (PRS) to reduce this high level of poverty and to achieve the Millennium Development Goals (MDGs). Reversing poverty trends and improving living standards is a *sine qua non* for maintaining the country's stability, while mitigating macro volatility.

Figure ES.1. Oil prices, Growth and the NFPS Fiscal Deficit



	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04
GDP Growth, LHS	4.4	3.4	-0.6	-2.5	3.8	2.9	4.1	-2.1	8.4	1.0	2.7	5.2	1.5	0.3	4.7	1.8	2.4	4.1	2.1	-6.3	2.8	5.1	3.4	2.7	5.5
NFPS Deficit	-5	-6	-7	0	-1	1.9	-5	-9	-5	-1	0.5	-1	-1	0	0.6	-1.2	-2.8	-2.1	-5.1	-4.6	1.0	0.3	0.8	1.7	1.8
Oil Prices, RHS	35	34	33	28	27	26	13	16	13	16	20	16	17	14	14	15	18	16	9	15	25	19	21	26	30

Source: World Bank staff's estimates.

4. **To strengthen the economy's resistance to shocks, reduce the high rates of poverty, and achieve the MDGs, this report highlights the need for public policy to focus on three main goals:** (a) strengthened fiscal sustainability; (b) increased fiscal space for pro-poor efficient and equitable public spending; and (c) improved budget management for results-oriented service delivery. These three objectives are closely interrelated. Given external vulnerability and dollarization, fiscal sustainability is a pre-requisite for poverty reduction, as nothing hurts the poor more than an unstable macroeconomy. However, meaningful poverty reduction also requires fiscal space, understood as the amount of non-wage expenditure devoted to poverty reduction, and resources shifted toward pro-poor priority programs, executed with efficiency and equity considerations. Furthermore, in a context of scarce resources, sound budget management is essential to eliminate waste and rigidities and improve service delivery.

Fiscal Policy Faces Historical and Structural Constraints

5. **To consolidate fiscal discipline, Ecuador must overcome the inherited effects of three decades of predominantly misguided fiscal policies before dollarization**. Public sector net worth declined between 1970 and 2000, and it has remained flat since then. Fiscal revenues are volatile and pro-cyclical. Past expansionary spending resulted in high deficits financed with mounting debt. In addition, budget rigidity due to earmarking repeatedly provokes serious liquidity problems for the national Treasury. These shortcomings are compounded by the political economy constraints. In the early 1970s, the prevailing regimes were shaped under the influence of the oil booms of those years. Their main features were those common in societies where rent-seeking is pervasive: acute competition for oil rents; conflict-prone social relationships; the social and political actors facing seemingly insurmountable difficulties to reach consensus; captured state by privileged groups tending to become the institutional locus where decisions on rent distribution are made and clientelistic favors and privileges are purveyed. As a

result, governance and institutions are weak, the efficiency and effectiveness of public administration becomes severely impaired and the opportunities for arbitrariness and corruption in the exercise of power multiply. Following this political-economy pattern throughout the last three decades, the internal connection between these regimes and the practices and institutions that frame the conduct of fiscal policy has been particularly noticeable in four systemic features, namely: (i) the large size of the Government and its role as a producer and provider of non-public goods and services, frequently at subsidized prices; (ii) the existence of a set of tax expenditures, whose function is to deviate (potential) government revenue to the private sector; (iii) the biased incentives that policymakers allocate toward short-term gains; and (iv) the widespread abuse of earmarking.

6. **To face these shortcomings, Ecuador chose a very demanding institutional framework for the conduct of economic policy.** While dollarization eliminates the risk of a currency crisis and the hyperinflation it entails, policy tools for demand management are severely restricted, and the buffer of the nominal exchange rate is no longer available. Moreover, for all its advantages for financial stability, dollarization in the context of an open capital account needs to be supported by a robust, well-regulated financial system.

Fiscal Trends and Challenges

7. **The first task is to consolidate the current trend toward fiscal sustainability**. Fiscal revenue is close to 25 percent of GDP, high by Latin American standards. This implies that while, non-oil tax receipts should be raised, expenditure adjustments rather than revenue increases must be the principal means to achieve a sustainable fiscal path. The current administration must deal with the fact that currently too much is spent on rigid and non-priority goods and services, and too little on pro-poor programs.

8. **The Government is not using high oil prices as an excuse for expansionary fiscal policy, despite the highest oil prices in more than two decades**. This restrained fiscal policy recognizes that Ecuador is still in a fragile fiscal position. Structural estimates of the fiscal stance confirm the prudent management of fiscal policy after dollarization. The average fiscal stance (the difference between the actual and "structural" budget balance) was a surplus of about 1 percent of GDP between 2000-03.

9. **Revenue management has improved significantly under the reformed Internal Revenue Service (IRS), but faces difficult structural constraints.** Since revamping the IRS in the late 1990s, for the first time in 30 years tax revenue has become roughly equivalent to non-tax revenue as a share of GDP. The IRS has a centralized taxpayers registry with crosschecking systems, and applies sanctions to non-compliers. However, the tax system remains segmented in a myriad of nuisance taxes (84 overall), and is burdened by extensive earmarking and a multiplicity of tax exemptions. Both earmarking and exemptions are costly (each accounting for about 4 percent of GDP in 2004) and increasing. Tax earmarking severely undermines budget management, since it promotes an inefficient and inequitable use of resources, and constrains the authorities' ability to reduce expenditure when needed.

10. **Although fiscal policy has been prudent in macro-economic terms, the existing spending structure is not conducive to poverty reduction: public wages and pensions have increased at the cost of cutbacks in public investment and social outlays.** Since 2000, non-financial public sector (NFPS) primary spending has been on an expansionary trend. This is

mainly propelled by wages and salaries, and contrasts with the constant trend maintained during the pre-dollarization period. This expansionary pattern indicates that the gains achieved by cutbacks in capital and social outlays, as well as in savings in interest payments, have been used to pay for the growing salaries and pensions.

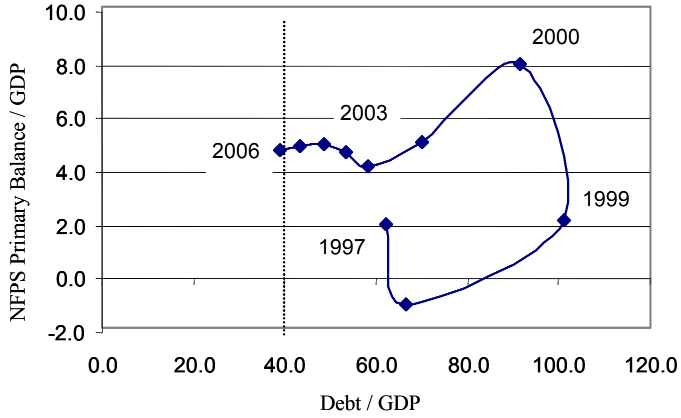
11. **The rapid increase in payroll spending is not mainly due to the size of the civil service, but to increases in wages.** The size of the Ecuadorian civil service is about average when compared to other Latin American countries. However, the rate of growth of the public payroll has been high. In real terms, the payroll grew 21.3 percent in 2001, 35.4 percent in 2002 and 19.5 percent in 2003. Not surprisingly, the share in current expenditure going to wages and salaries almost doubled in the last four years, rising from 25 percent in 2000 to 45 percent in 2003.

12. **The changes in the sectoral composition of government expenditure also constraints social outlays.** Social expenditures remain low and have slightly declined in the last two years. In 2004, education and health spending accounts for about 4 percent of GDP, about half the LAC averages of 7.5 percent of GDP. Social assistance, an important element for preserving a safety net on vulnerable sectors, accounts for about 1 percent of GDP. At the same time, military spending, at about 3 percent of GDP, is twice as high as the Latin American average of about 1.5 percent of GDP, and on the rise, following the increased military activity in neighboring Colombia.

13. **To deepen its fiscal consolidation, Ecuador implemented an oil stabilization fund together with well-defined fiscal rules.** The FRSTL created an oil fund (FEIREP) with the objective of stabilizing fiscal revenues, repurchasing debt and saving some funds for education and health. Quantitative rules were introduced on the growth of the Central Government real primary spending (3.5 percent a year), non-oil deficit reduction (0.2 percent a year), and debt ratio reduction (toward a ceiling 40 percent of GDP in the medium term). The Law also introduces constraints on subnational debt and rules on fiscal transparency. The creation of the fund is positive for preserving government's net worth. However, estimates show that the current rules might force the government to save too much at certain times and not enough at others; that resources allocated to its stabilization (countercyclical) component are less than optimal for providing full insurance; and that if its design were improved, the mandatory reduction of the non-oil deficit at an annual pace of 0.2 percent of GDP might be eliminated once public debt reaches 40 percent. In the short term, however, making the fund comply with its mandated role is critical, and any change to its rules for political reasons would damage its credibility.

14. **A preliminary assessment indicates that compliance with fiscal rules has been reasonable so far**. In 2004, the rules governing planned real primary spending and the non-oil deficit were met. The scheduled reduction of public debt-to-GDP ratio was also on track in 2003. On the execution side, however, performance was mixed: the executed real primary expenditure, instead of increasing, fell by almost 1 percent of GDP in 2003, and the non-oil deficit reduction was not achieved in 2003, after two consecutive years of reduction. However, the reduction in the public debt-to-GDP ratio of about 5 percent of GDP in 2003 was consistent with high primary surpluses devoted to reach the mandated ceiling target of 40 percent of GDP in 2006 (Figure ES.2).

Figure ES.2 Debt Sustainability under the Fiscal Rule



Source: World Bank staff's estimates.

15. **Despite this positive performance, debt sustainability remains vulnerable to shocks, as a debt sustainability simulation illustrates**. A 50 percent drop in the price of oil from US$24 to US$12 per barrel would lead to a drop in export proceeds and to a 33 percent depreciation of the real exchange rate. Tradable goods would become more expensive relative to nontradable goods and this will lower the value of output—that has a large nontradable component—thus leading to an increase in the debt-to-GDP ratio. The 50 percent drop in the price of oil would also require an increased primary balance from 4.5 to 5.2 percent of GDP, that is, almost 1 additional point of GDP, just to sustain 2003 levels of debt. And if this shock were accompanied by an increase in 200 basis points in interest rates and a fall of 1 percentage point in GDP growth, then the required primary surplus for debt sustainability would rise to about 7 percent of GDP. These numbers illustrate potential risks for the future.

Pro-Poor Expenditure and the Room for Additional Fiscal Space

16. **The Government recognizes that the present fiscal stance is inconsistent within the framework of a poverty reduction strategy.** Its objectives are to take advantage of the process leading to the PRS to improve the amount and quality of public expenditures: level, composition, and targeting. To help assess these objectives, this section addresses the following issues:

- Trends in social outcomes, particularly in education and health
- Trends in pro-poor expenditure
- Finding fiscal space to increase spending for poverty reduction

Trends in Social Outcomes

17. **Educational outcomes continued to improve during the 1990s and into the new millennium:**

- There has been continuous growth in the average level of schooling since the 1970s: in 2001, the average adult had completed 7.3 years of schooling, up from 6.7 years in 1990. This level is above the Latin American mean, and is about the same as East Asia.
- By 2001, the gender gap had practically been closed: 7.5 years for males compared to 7.1 years for females. Educational levels of the female population have risen much faster than that of males, such that, in terms of net enrolment rates, girls already outperform boys at all educational levels.
- Net enrolment in primary education increased from 88.9 to 90.1 percent between 1990 and 2001, approximating the MDG of primary education for all.

18. **Health indicators have also improved:**

- Life expectancy at birth increased from 48 years to 72 years between 1950 and 2000. This upward trend was sustained during the 1990s, adding another 5 years to life expectancy.
- Parallel declining trends are found in child and infant mortality rates. The overall mortality rate dropped from 13.8 per 100,000 inhabitants in 1960 to 4.5 per 100,000 inhabitants in 2001. This rate did not change much during the 1990s. In contrast, since 1970, the infant mortality rate fell by 70 percent in Ecuador, which is an impressive achievement. The infant (aged 0–1) mortality rate has followed an almost linear trend since 1950, reaching 33 per 1,000 live births during 1995–2000, down from 140 during 1950–55. Child (aged 1–5) mortality rates follow similar trends (WHO 2003).
- The drop in infant mortality coincides with a long-term decline in fertility rates. Fertility dropped from almost 7 per woman in the 1950s and 1960s to 2.8 during 2000–05. During the 1990s, fertility dropped faster in rural than in urban areas, but the rate is still 1.5 times higher for rural women.

19. **Important concerns, however, remain in the education sector**. The transition rates from primary to secondary education and from secondary to tertiary did not improve in the 1990s. Significant disparities remain, particularly affecting rural, indigenous, and black populations. The average level of schooling of the rural population is less than half the one of the urban population, and the gap is even larger for the indigenous and black populations. This is also the case for illiteracy rates. Overall education quality is poor, with math and language test scores worsening between 1996 and 2000 and starting from an extremely low baseline (Ecuador scores lowest for the Latin America region). Internal efficiency indicators, measured by desertion and repetition rates, have also worsened, with the number of years pupils need to complete primary education increasing from 6.7 years to 6.9 years between 1995 and 2001; and higher dropout by girls in secondary rural schools and by boys in urban schools, seemingly for economic reasons. Finally, retention rates and education quality also appear affected by the high rate (14 percent) of teacher absenteeism and frequent teacher strikes in Ecuador

20. **Similarly, concerns appear in the health sector that will put pressure for additional financing.** The decline in fertility and the increase in life expectancy are changing Ecuador's demographic profile. The causes of mortality are moving away from traditional child diseases (malnutrition, respiratory and infectious diseases) toward diseases associated with higher levels of economic well-being and urban lifestyle (cardiovascular and cancer health risks). Preventable diseases remain the main causes of child (1 to 5) and infant (0 to 1) mortality. The prevalence of AIDS has increased, with 10 times more cases reported in 2002 than in 1990. Finally, malaria trends remain closely associated with the occurrence of the *El Niño* effect.

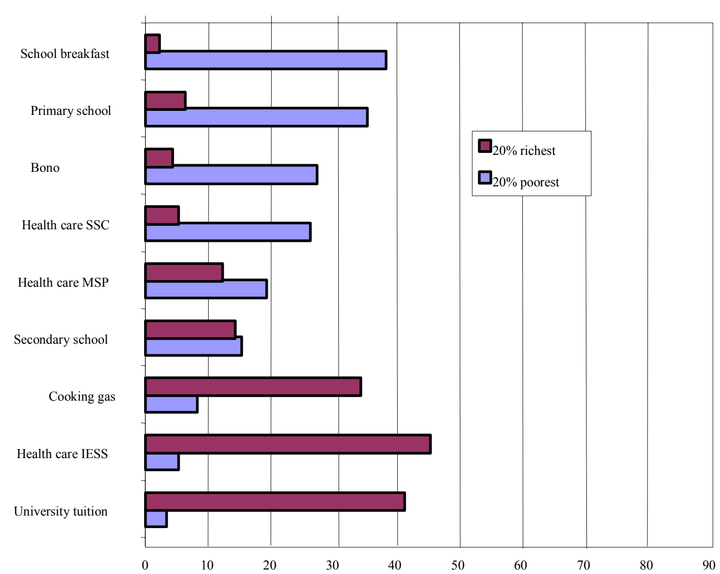
21. **Selected MDGs in education and health are within reach, however, especially if supported by additional social expenditure, well targeted, effective, and financed by low-cost programs explicitly linked to specific outcomes.** Positive educational and health outcomes have been obtained despite low education and health budgets, apparently poorly functioning education and health systems, a significant amount of non-pro-poor spending in both sectors, and a high incidence of malnutrition. Continued overall improvements in education, urbanization, fertility rates, and sanitary conditions explain these seemingly paradoxical

outcomes. However, no linear extrapolation guarantees that these trends will continue. This is why a pro-poor shift in social spending is desirable.

Trends in Pro-Poor Expenditure

22. **About half of social spending and all subsidies to basic services are not pro-poor**. In a context of fiscal adjustment, making better use of resources is essential to reduce poverty. Government spending on education and health could be better spent to achieve improved educational and health outcomes and greater equity. In education, while primary education and to a lesser extent secondary education are pro-poor, spending in tertiary education is heavily skewed against the poor. This is all the more worrisome considering that spending in primary and secondary education has had a constant share in the total sector budget since 1995, but higher education has received about a 33 percent increase over the same period.

Figure ES.3 Incidence of Social Expenditure, 1999



Source: Table 3.1.

23. **Incidence analysis also points out to significant non pro-poor spending in social expenditure**. Taking the difference between the richest and poorest quintiles, it appears that the school breakfast, primary school spending, and the *Bono* cash transfer, in that order, are the most pro-poor programs (Figure ES.3), despite significant targeting problems in their implementation. At the bottom of the classification, university education, IESS health care and the cooking gas appear to be the most non-pro-poor outlays.

24. **Furthermore, none of the three subsidies to basic services—water, telecom, and electricity—caters to the poor, and they are highly distortionary from an efficiency perspective.** These subsidies represent a big drain for the government resources: about 1.3 percent of GDP. The implicit subsidy for telephone service is the most unequally distributed, followed by the water subsidy. Electricity is the largest subsidy. While tackling the telecom and electricity subsidies is a priority for the central government, dealing with the water subsidy requires collaboration with subnational governments.

25. **The efficiency of expenditure on basic infrastructure also has significant shortcomings**. There are high losses in the power sector due to theft and inappropriate billing; the water and sanitation sector has massive shortfalls of resources in non-wage and maintenance expenditures due to significant cuts in transfers to municipal governments, and the telecom sector has low operational surpluses due to low and distortionary rates against the poor.

Telephone penetration was almost 10 times lower in the poorest quintile and only 1 out of 20 rural people has telephone service.

Finding Fiscal Space to Increase Spending for Poverty Reduction

26. **Rigid expenditure limits fiscal space for poverty reduction.** Central government expenditure has become increasingly rigid, leaving almost no fiscal space for development needs. In 2004, wages and salaries account for 32 percent of total spending, earmarked transfers, inertial services and investment are 34 percent, and debt service is 30 percent, which adds to 96 percent of the total budget, up from 86 percent in 2001. This means that the non-rigid and non-inertial spending barely represents 4 percent of the total budget, leaving a very small residual fiscal space—no bigger than half a percent of GDP—for freely allocated public investment**. Should this pattern continue, and the residual fiscal space that could potentially be allocated to investment in poverty reduction would fully disappear by 2006.** Reversing this situation points out to the urgent need to explore possible sources for creating additional fiscal space within the fiscal aggregate ceiling allowed by the fiscal rule.

Table ES.1 Potential Sources of Fiscal Space and Estimated Annual Impact

Measures	**Percent of GDP**
On-budget	
Curb capital spending ratio toward its "structural" level (budget reallocation)	0.2
Interest savings from debt repurchase	0.2
Reduce defense spending to end-1990s level	1.0
Make optimal use of public spending (Competitive-based Fund)	0.2
Off-Budget	
Reduce selected off-budget earmarking of oil revenues	0.6
Incorporate all oil-subsidies to budget (gas, diesel, and electricity)	2.3
Eliminate 25 percent of overall tax exemptions	1.0
VAT	0.7
Internal	0.3
External	0.4
Income	0.3
Firms	0.2
Individuals	0.1
Rationalize spending of ORDs	NA
Integrate 10 percent of subnational spending with national priorities	0.4
Allocate resources from Solidarity Fund to the PRS	0.1
TOTAL	**6.0**

Source: World Bank staff calculations.

27. **The Government could create fiscal space of up to about 6 percent of GDP**. This is a considerable margin, considering that only 1-2 percent of GDP would be needed to achieve selected MDGs in education and health (Table ES.1). These estimates assume that the Government decides to maintain a constant tax burden, curbs expansionary spending in the payroll and pensions, and improves the pro-poor content of expenditure policies. The additional fiscal space would also contribute to a further reduction of non-priority expenditure required to compensate for any revenue loss emanating from a fall in oil prices or another external or domestic shock. In addition, the Government could create fiscal space for increased pro-poor

spending, especially in the education, health, and social protection sectors, by: (a) revising the current allocations of social expenditure and programs through the development of a competitive-based fund; and (b) making better use of the available targeting instruments, like SELBEN, to unify criteria and consolidate programs. Notice however, that whatever solutions are adopted, they will have to be accomplished within the annual fiscal ceiling mandated by the FRSTL. The existence of this ceiling, and the little room for tax reform implies that the main effort will have to come from expenditure shifting activities.

28. **An input–output model developed as part of this report identifies the main inputs that determine achieving key MDGs**. It is possible to identify inputs required for reaching at least the three MDGs of universal primary and secondary education enrolment and reduced infant mortality. These can be achieved with four cost-effective programs: teacher training and the expansion of the *Bono de Desarrollo Humano* for primary and secondary education, and expansion of the coverage of the immunization and Free Maternity programs for infant mortality.

Public Expenditure Management (PEM) and Other Institutional Issues

29. **Developing an effective poverty reduction strategy for Ecuador requires, as a precondition, an overall reform of the budget process and, more broadly, of all levels of PEM.** A sound PEM is the key policy instrument that articulates the country's fiscal ceilings and rules with, on one hand, priorities reflected in the budget and, on the other hand, improvements in public sector performance and service delivery. Hence, PEM reform requires an enhanced performance of the budgeting system, rapid upgrading of its budget and financial management procedures, a complete overhaul of budgeting procedures by social agencies in charge of priority social programs and of provincial and sectional governments receiving transfers, transparent information access at all levels of government to allow results-oriented budgeting in the future, and, only when these reforms have gained ground, a multi-year budgeting framework (MYBF) that would allow aligning expenditure inputs with expected social outcomes. At present, Ecuador is not ready for a MYBF.

30. **Since 2003, Ecuador has taken steps to improve its overall PEM.**

- The passage of the Fiscal Law in 2002 set quantitative rules for budget formulation, laying the groundwork for multiyear budgeting, and requiring subnational entities to submit monthly revenue and expenditure reports.
- The country has been prudent in its budget formulation and assumptions; while attaining with an acceptable aggregate level of budget under-execution (below 5 percent);
- It has reinitiated the extension and modernization of the coverage of its integrated financial management system (SIGEF) with the goal of producing consolidated balances for 90 percent of the central government by 2005;
- A single database for central government-financed public investment has been built;
- An inter-bank payment system (IPS) of public employees located at the Central Bank has started to develop a central registry database for all government employees at SIGEF; and
- CONTRATANET, an electronic public procurement system, has been set up on a pilot basis, initially as an informational—not yet transactional—system.

31. **Despite these improvements, a standard global assessment carried out as part of this report shows that the country ranks poorly in all but one of the 16 international PEM benchmarks.** Benchmarks refer to overall budget formulation, monitoring, execution, control and reporting procedures. A survey developed by this study shows that the country ranks in the bottom tier, even when compared to heavily indebted poor countries (HIPCs). The survey findings are confirmed by parallel studies in standard transparency rankings (ROSC) prepared by the IMF, and the Country Financial and accountability Assessment (CFAA) jointly prepared by the World Bank and the Inter-American Development Bank (IADB).

32. **The most important weaknesses are:** (a) poor and inertial budget planning, with a bias in favor of defense and security forces and against spending in the social sectors; (b) the presence of significant off-budget funds; (c) poor Treasury management, reflected in arrears, cash rationing and long delays in the transfer of resources to social programs; (d) absence of a results-oriented framework; and (e) an outdated integrated financial management system that does not allow timely and reliable reporting on budget execution, which affects monitoring and limits transparency, control and public oversight of fiscal accounts.

33. **Poor performance of social expenditure in Ecuador is closely linked to PEM shortcomings**. Recent reviews of international experience with poverty reduction strategies have concluded that in many countries, the practice of PEM is an obstacle to the achievement of poverty reduction objectives. Ecuador is no exception. Failures in the budget process and institutional bottlenecks systematically lead to underexecution of social programs. These shortcomings result in underbudgeting or in long interruptions and delays in the channeling of budgeted resources. Perhaps the most important failures are unrealistic budget planning, wide variations in deviations between budgets approved and executed—with a bias in favor of defense and security forces and against spending in the social sectors—a lack of effective interventions resulting from budget fragmentation through a myriad of overlapping social programs and the presence of significant off-budget funds, and delays in the actual transfer of resources, arising from cash rationing and poor execution capacity at the level of line agencies. Arrears have been declining since 2000, but a sizable financial gap of about US$548 million still remained for 2004 by mid-year.

34. **Weaknesses in the budget processes and institutional bottlenecks play a major role in the poor performance of social programs and municipal spending.** Recent reviews of international experience with poverty reduction strategies have concluded that in many countries, the practice of PEM is an obstacle to achieving poverty reduction objectives. Ecuador is no exception. A review of budgeting procedures in both selected social programs and subnational governments done as part of this report also identifies important shortcomings.

35. **In the priority social programs, shortcomings are multiple**. A lack of effective interventions and budget under-execution result from budget fragmentation through a myriad of overlapping social programs, which have grown increasingly fragmented and disorganized. There are 45 social programs and some are duplicative. Long interruptions, delays and deviations exist in the channeling of budgeted resources to priority social programs. Cash constraints are particularly acute in the first semester of the year. Excessive bureaucratic controls also play a role in delaying compliance with budget allocations. Most performing social programs are those which have their own budget execution capacity (and financing mechanisms) and little intermediation from ministries.

36. **In provincial and municipal governments, budget procedures replicate similar weaknesses observed at the central government**. This is the case in terms of inertial budgeting, low predictability of transfers, absence of national directives, and poor reporting. However, this report finds that since 2003, MEF has over-complied with committed transfers to provincial and sectional governments, which reflects that fact that Treasury's cash rationing has been unequally applied in the public sector. Unfortunately, this has not been accompanied by increased accountability and responsibility, thus weakening the framework for fiscal discipline at the subnational level and opening the door for wasted and unreported resources transferred to subnational governments and for irresponsible subnational borrowing.

37. **Fiscal discipline and implementation of an effective poverty reduction agenda could be facilitated by a reform of all levels of PEM.** Sound PEM is the instrument that articulates the country's fiscal ceilings and rules with, on the one hand, priorities reflected in the budget and, on the other hand, improvements in public sector performance and service delivery. To ensure the fiscal discipline needed to support dollarization, the Government should first set the annual ceiling of fiscal balances. Then, based on such a constraint, a shift to pro-poor allocations of expenditures would be easier to implement with an improved expenditure management process that is strategic in focus, feasible in terms of available fiscal space, and results-oriented with proper monitoring and evaluation mechanisms.

Conclusion and Policy Recommendations

38. **Ecuador's impressive fiscal performance of 2003 is encouraging, but fragile.** Several structural bottlenecks could impede fiscal discipline and recovery, which is a pre-condition to develop a poverty reduction agenda. Tax earmarkings and exemptions and an expansive payroll and pensions bill have reduced to a minimum the available fiscal space for development needs. Reversing poverty trends is critical for the country's stability, and this can only be achieved with well-targeted, effective and efficient pro-poor programs. The *status quo* is not an option for poverty reduction.

39. **Preserving a sound fiscal position and deepening positive social outcomes is well within reach.** Among the country's many strengths are: a prolonged oil windfall; the existence of and compliance with fiscal rules; decreasing arrears that should fully disappear in 2004, substantive progress on social outcomes despite decreasing budgets; and a series of on-going reforms on budget management. Last September an important test was the Government's capacity to successfully resist short-term election-motivated pressures for amending the fiscal rule in order to misuse FEIREP resources. The lessons from international experience on the implementation of poverty reduction strategies suggest three guiding principles

40. First, the GOE needs to articulate the message that its fiscal management reforms are designed to help the poor. If reforms are to succeed, they have to be pro-poor. Ecuador's fiscal stress and poor budget management is deeply rooted in a governance system benefiting the elites, be it reflected on pro-rich subsidies, especially on basic infrastructure; off-budget operations that prevent transparency and foster corruption, or regressive transfers to subnational governments explained by party politics. The challenge for the Government is to provide more effective, efficient, sustainable and equitable assistance to the poor.

41. Second, the reform of the fiscal management agenda needs to be designed and implemented with a medium-term view and national consensus. Piecemeal, short-term reforms

can only bring short-term, often not long lasting gains. For example, the creation of Contratanet allowed the surge of an informational system about public procurement that has improved its transparency, but the more difficult task to converting it into a transactional system still remains to be undertaken. The establishment of a commission to draft such bill and the commission's decision to consult with civil society on the draft are steps in the right direction.

42. Third, the implementation of the PRS has to be monitored in an transparent way. Sharing reliable and timely information is as critical as the strategy itself. In the absence of transparency, the strategy loses credibility. This requires a combination of several steps including the development of benchmark indicators, not only fiscal, but especially social—inputs, outputs and outcomes. These should be designed in such a way that they can be monitored on a regular basis and reported before the Legislature and civil society. In addition, client surveys could be commissioned to assess the quality of service delivery. All reports should be made public.

Policy Recommendations

43. To address the challenges faced by the Government in its fiscal policy, this report recommends an agenda of policy actions that would promote the three key objectives of fiscal stability, pro-poor spending, and budget management. While fiscal reforms face formidable political-economy and institutional obstacles in Ecuador, increasingly large segments of public opinion may be won over to the pro-reform camp if a close connection between the need for fiscal adjustment and the creation of the fiscal space needed for a poverty reduction strategy is spelled out to the citizenry.

44. **The medium-term objective of fiscal policy in Ecuador remains to preserve the sustainability of the fiscal accounts under explicit or implicit Fiscal Pact.** The means to deal with the public sector's insolvency risk; eliminate the structural bias toward expenditure expansion in the management of public finances; address the issue of the Treasury's short-term liquidity problems; and comply with the fiscal rule requirements in the short tem (thereby building credibility). The rule could be amended in a few years to make it a sharper, more coherent, and more powerful instrument for fiscal consolidation. More specific recommendations in this area include the following:

- Ecuador needs to lower its insolvency risk by producing and preserving the high primary surpluses needed to gradually reduce the debt-to-GDP ratio to the sustainable levels of 40 percent of GDP in the period 2006-2007. An important caveat is that while the FRSTL sets 40 percent as the goal, and this is a reasonable achievement, an additional 5 percent reduction would be desirable for unexpected contingencies and shocks.
- The Government should realize that the pursuit of a comprehensive tax reform becomes irrelevant in the medium term if it is able to adopt some measures that are proposed in this report to create the fiscal space.
- As the adoption of revenue measures is politically constrained in the short-term, curbing the bias towards expenditure expansion, especially on the payroll and pension benefits, should be the top key priorities of fiscal policy.
- Regarding FEIREP, in the short-term strict compliance with the mandatory use of 70 percent of FEIREP funds to repurchase the most expensive debt first (particularly in global bonds), is

needed to reduce interest payments. If the country complies with projected debt reduction repurchases, it would save an average 0.2 percent of GDP, which would be available for pro-poor programs. In the medium term, legal amendments to the FEIREP and fiscal rules would improve the fund's effectiveness. Possible amendments include the redefinition of the reference price for crude oil that is included in the budget. Another is to apply the criterion of the 3.5 percent real growth rate for primary expenditures with reference to the executed budget of the previous year, as opposed to the approved budget. A third is the elimination of the 0.2 percent of GDP mandated non-oil deficit reduction, once the country reaches the 40 percent of GDP ceiling and oil proceeds for stabilization purposes can be increased.

- Given the large country risk premium on public debt, and findings from the debt sustainable analysis, oil revenues should reduce public debt to 40 percent of the GDP and, later, accumulate financial assets that would eventually allow the country to have a small non-oil deficit, even after oil reserves are depleted. The external debt buyback should be accompanied by additional fiscal space to buffer the impact of future shocks and streamlined expenditures. Debt buyback is no substitute for expenditure rationalization. Besides, by following the proposed debt strategy, it may be more difficult and costlier to borrow internally if Ecuador faces a shock, because developing countries, in contrast to developed countries, cannot borrow commercially when they suffer a shock.

- The Treasury's short-term liquidity difficulties badly affect the authorities' credibility and the country's reputation. Given the specific composition of the public debt, closing the liquidity gap is critically dependent on the Government's willingness and ability to design programs of substantial structural reforms. This would be the basis for an agreement with the IMF and would enable the country to obtain rapidly disbursing and freely disposable funds. This is also the road to enhanced credibility for the medium-term debt reduction plan.

45. **Shifting public expenditure toward a pro-poor focus involves actions on several fronts.**

- <u>Basic Infrastructure Subsidies</u>: (a) reduce the total electricity subsidy provided to consumers below a maximum amount of electricity consumption, since the actual ceiling of residential consumers below 300 kilowatt-hours is too high to target the truly poorest households; (b) reduce tariffs for public telephones, which are 10 times higher than tariffs for residential users, and eliminate cross-subsidies through completion of the tariff rebalancing between domestic and international rates approved by CONATEL in 2003; and (c) reduce and make transparent cross-subsidies in the highly decentralized water and sanitation sector, linked to operational performance, while defining the amount of subsidy allocated per connection considering the size and income level of the population.

- <u>Expenditure on social services:</u> (a) freeze or reduce subsidies to university tuition to finance access for poorer groups, for instance, to secondary education; (b) increase the very small budgets of pro-poor programs, like primary education, the school breakfast or the Free maternity Law; and (c) introduce results-oriented budgeting to all pro-poor programs, by defining monitoring indicators, undertaking regular monitoring and evaluation mechanisms, and allowing strong civil society participation.

- <u>Link and protect budget support to MDG goals and improve its performance</u>: (a) provide additional budget resources (for about 0.1–0.2 percent of GDP) to primary education and infant mortality; (b) focus additional resources in secondary education, child malnutrition, basic health, and child care, which would raise additional budget needs to about 0.8 percent of GDP in 2004, 1 percent of GDP in 2005, and almost 2 percent of GDP in 2007; and (c) define a set of performance indicators that would allow their progress monitoring. Indicators should result from a combination of a consensus-building exercise and international expertise. An important conclusion of this approach is that not all sector and program budgets need to be linked to performance indicators, but only the ones that are critical for achieving the goals of the PRS.

46. **A reform of public expenditure management is essential to accompany poverty reduction**. This includes implementing a budgeting system that reverts inertial expenditure; rapidly upgrades the budget and financial management system (SIGEF); overhauls budgeting procedures by both social agencies in charge of priority social programs and subnational governments receiving transfers; makes information access transparent at all levels of government to promote participation; and, only when previous reforms have gained ground, establishes a multi-year budgeting framework that align expenditure inputs with expected social outputs. More specifically, the following measures are suggested:

- On overall public expenditure management: (a) create a Cash Committee at MEF composed of representatives of all offices that manage budget design and execution; (b) revert inertial budgeting through already adopted freezing of the wage payroll; (c) gradually integrate off-budget activities into the Treasury's Single Account (*Cuenta Única*), especially non-constitutional earmarkings and subsidies currently channeled through PetroEcuador; and (d) overhaul SIGEF to promote proper registration and timely information of budget execution. An important step in this direction has been done with their publication in the 2005 budget.

- On budget management in social programs: (a) review the overall budget protection policy with an initial assessment of the number of social programs and the amount of resources allocated to them effectively representing government priorities, with programs receiving the minimum amount of resources needed to achieve their goals; (b) merge or eliminate duplicate social programs to reduce resource waste following the example of the nutritional ones under the *Sistema Integrado de Alímentación y Nutrición* (SIAN); (c) eliminate cash constraints in the first half of the year, a recurrent and severe problem in many agencies; (d) rationalize, simplify, and if possible automate, budget procedures and forms for requesting reimbursement of payments; and (e) consider the creation of "virtual" poverty fund. Obvious candidates for elimination are those programs that show a significant degree of low budget execution and/or poor targeting.

- On budget management in provincial and sectional governments: (a) design a strong regulatory and institutional framework that clearly assigns expenditure responsibilities in line with subnational governments' administrative capacity; (b) condition delivery of some or all transfers on timely and reliable budget reporting by subnational governments, as mandated by the FRSTL and following up upon recent MEF efforts for building a database on subnational fiscal accounts; and (c) promote responsible subnational borrowing by establishing further norms under which the central government can intervene in local governments when and if they violate the fiscal rules, and clearly excluding the possibility of a bailout.

A Selection of the Key Policy Recommendations

Based on the analysis done in this report, and among the set of recommendations proposed, the following sub-set of sequenced priority actions are suggested:

I. High Priority for the near term (6–12 months)

1. **Obtain primary surpluses between 4.5-5 percent of GDP**. This could be achieved in the short term by reducing spending and by complying with the fiscal rule. Current primary spending should be curbed by preserving until 2005 the on-going freeze of the public payroll and maintaining pensions at their 2003 level in real terms.
2. **Comply with mandated debt reduction** using 70 percent of FEIREP proceedings for repurchasing of external debt.
3. **Announce a draft budget reform bill** to: (a) integrate off-budget activities, especially subsidies paid by PetroEcuador; (b) freeze or reduce non-constitutional budget earmarkings; and (c) reduce central government 40 percent contribution to IESS.
4. **Create a Treasury Committee** that manages and makes transparent current cash strapped budget execution.
5. **Ensure SIGEF overhaul** by: (a) fulfilling its commitment to consolidate fiscal accounts; (b) producing timely disaggregated reports in the MEF website; and (c) completing its re-design for moving to an internet-based system.
6. **Undertake a comprehensive review of budget protection policy** to: (a) weed-out non-performing priority social programs and select the most performing ones under a "virtual" poverty fund; (b) merge most of the remaining overlapping ones following the example of the nutrition ones under SIAN; (c) guarantee a high level of execution of their budget agreed for 2004 and 2005; (d) commit additional resources required by compliance with selected MDGs in the 2005 budget.

II. Priority for the medium term (1–3 years)

1. **Amend the Fiscal Transparency, Stabilization and Responsibility Law**, ensuring that: (a) quantitative rules apply to *executed,* not only *approved* spending, (b) resources for the anti-cyclical role of FEIREP are augmented, once the ceiling 40 percent debt-to-GDP ratio is attained; (c) additional rules are introduced for subnational governments; and (d) provincial and municipal governments comply with the transparency requirements contained in the fiscal rule.
2. **Adopt decisions on policy alternatives proposed for creating fiscal space in the context of an implicit or explicit Fiscal Pact (see Table ES.1)**. This implies expenditure shifting activities. Tax reform, in particular, should expand the tax base by reducing tax exemptions, and continue improving tax administration.
3. **Increase the level of education, health and social protection budgets, while raising their quality and share devoted to pro-poor programs.** This implies to focus additional spending on (a) teachers' training and secondary education, on health provision by the Free Maternity Program, and on the revamped *Bono;* (b) pro-poor programs (possibly supported by a Competitive-based Fund); (c) other priority public investment, especially if it is donor-financed, which would require close coordination through sector approaches.
4. **Freeze or re-target non pro-poor subsidies and spending on non pro-poor social programs** in nominal terms at their 2003 level, especially for higher education and pensions. Retargeting of the cooking gas, diesel, and electricity subsidy is a priority.
5. **Develop a strategic vision for electricity, water, sanitation and telecom sectors**, accompanied by a time-bound implementation plan, to: (a) expand coverage; (b) improve service provision; (c) reduce regressive subsidies; and (d) allow for private competition for service provision among suppliers and accountability to users.