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THE POLITICAL ECONOMY OF THE BUDGET PROCESS: THE CASE OF ECUADOR

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Foreword

During the last decade, most Andean countries implemented a set of fiscal reforms aimed at strengthening public finances, enhance resource allocation and contribute to macroeconomic stability. However, despite recent improvements in fiscal performance, public finances remain vulnerable, fiscal policies have often been pro-cyclical and debt sustainability continues to be a challenge in the region. Although considerable attention has been given to fiscal rules and institutional reform to address some these weaknesses, there is a growing effort to try understand the outcomes of fiscal policies from a political economy perspective.

Understanding the budget process as the arena where decisions regarding the use of public funds take place and society faces constraints and trade-offs regarding the use of its resources is a key ingredient to provide useful recommendations for improving public expenditure management in Latin American, and ultimately increase the sustainability, efficiency, and representativeness of public expenditures.

This study presents the case of Ecuador. The report describes the main actors (formal and informal) involved in the budget-making process, and presents evidence regarding the main political and economic determinants of fiscal performance. It also discusses whether different political and institutional arrangements governing the budget process affect incentives for the composition of the budget.

This study is part of "The Political Economy of the Andean Countries" project financed by United Kingdom Department for International Development (DFID) and coordinated by Fidel Jaramillo, Regional Economic Advisor of the Regional Operations Department 3 (RE3), Ernesto Stein, Principal Economist of the Research Department (RES), and Carlos Scartascini, Senior Research Economist (RES).

This project complements other recent efforts in this field : (i) the Budget Practices and Procedures Survey, launched by the OECD and the World Bank with the support of the IADB, and (ii) other IADB initiatives like the 2006 Social and Economic Progress Report (IPES) "Understanding the Politics of Policies", and the Research Network Project "Political Institutions, Policymaking Processes, and Policy Outcomes" (PMP).

"The Political Economy of the Budget Process: The Case of Ecuador" was prepared by the following : Andres Mejía (Institute of Development Studies, University of Sussex), Vicente Albornoz (Corporación de Estudios para el Desarrollo) and M. Caridad Araujo (World Bank). The authors wish to thank Emmanuel Abuelafia, Mark Hallerberg, Jose Hidalgo, Diego Mancheno, Tom Mustillo, Olga Nuñez and several other participants at the IADB workshops in Bogotá, Quito and Washington for providing helpful comments. A special thanks to Jesus Bengoechea (RE3) who was in charge of the preparation of this publication.

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Introduction

The budget process is the policy arena par excellence where distributional conflicts from society are channeled through formal institutions and rules in repeated and predictable political interactions. This paper seeks to fill a gap in the scholarly literature by analyzing the formal rules, incentives, and coalition dynamics of the relevant budget players behind the process of design, approval, execution, and oversight of budgets. Earlier works have focused on quantifying the magnitude of the association between political institutions (elections, party systems) and different measures of fiscal performance (fiscal balance, debt to GDP ratio). In turn, the current research agenda requires a systematic analysis of the different arenas and stages in which budgets are made. The executive, local governments, and organized interest groups have significant agenda setting powers; the national legislature embodies the regional and ideological ambitions of diverse constituencies; and diverse bureaucratic agencies are empowered to execute and monitor budget allocations. These interactions are also guided by the fiscal and electoral calendars, thus providing predictable incentives for cooperation or defection. The variable of interest is the quality of budget outcomes, a composite notion that seeks to evaluate four dimensions of budget performance: whether budgets allocations are representative of the interests of the majority, are sustainable over time, are efficiently allocated, and can be adaptable to changing economic circumstances.

The paper tests the validity of the proposed analysis of budget dynamics in Ecuador, a country where major political and economic transformations of recent years, including the adoption of considerable constitutional reforms in 1998 and the move to dollarization in 2000 should have altered the representative, efficiency, flexibility, and sustainability of budget outcomes.

The budget process in Ecuador takes place in a contentious policymaking environment characterized by high dependency on oil revenues, unstable budget institutions, and generally uncooperative political actors. Oil revenues, when available, alleviated distributional conflicts among short-sighted rent seekers at the expense of fiscal discipline. Political fragmentation was often an obstacle to the possibility of updating obsolete fiscal rules or providing adequate policy responses to unexpected external shocks. Two recent events have further altered budget dynamics, including the time horizons, rent seeking incentives, and arenas of interaction of key budget players. At a first glance, the 1998 Constitution and adjacent political reforms reduced transaction costs around the budget process, by granting larger agenda setting powers to the president, and effectively marginalizing legislators from the process. The move to dollarization in 2000, and the subsequent adoption of the Fiscal Responsibility Law in 2002, further reduced the discount rate of political actors and formally imposed other restrictions that allowed to enforce fiscal discipline.

Overall, empirical findings assessing the effect of these major policy changes on budget outcomes suggest that:

1. Budget outcomes in Ecuador are more sustainable (less vulnerable to shocks), by looking at public debt outstanding, if oil prices remain high. This feature is partly explained by formal and de facto incentives to fiscal discipline imposed by Constitutional reforms and

dollarization, but sustainable outcomes remain mostly sensitive to variations in oil revenues.

2. Budget outcomes are more efficient, measured by lower levels of budget reallocations during the process as well as more efficient education spending. The shift is partly explained by the greater agenda setting power of the president to make budgetary allocations, and the limited ability of legislators to bargain budget allocations for their constituencies during the budget process.
3. Budget spending has become less representative, as measured by per capita spending by province. This outcome is observed despite the adoption of electoral and constitutional reforms designed to increase political representation.
4. Budget outcomes have become more rigid (less flexible) over time, as measured by the levels of earmarking of revenues and expenditures. Some earmarked expenditures rose to constitutional level in 1998 (like 15% of the budget for local governments) and after 2000 some taxes and oil revenues have been further earmarked.

This paper explains that the net effect of both sets of reforms, the new constitution and dollarization, was to "squeeze out" of the budget process the incentives for political bargaining. Given the fact that presidents had greater powers to set agenda and legislators lost access to bargaining budget allocations for their constituencies, we argue that these key budget players lost incentives to form budget coalitions in the national arena. Instead, this paper begins to document a significant "shift" of political dynamics to the sub national arena. We argue that the municipal and provincial governments have become central characters in the political process and are effective in influencing budget allocations and shaping budget dynamics. The empowerment of the executive helps the interpretation of more "efficient" budget outcomes; high oil prices and self-imposed constraints to the spending of oil revenues explain more "sustainable" budget outcomes; whereas the shift to the sub national arena helps explain an observed bias of budget spending towards certain provinces and a greater earmarking of resources which benefit -directly or indirectly- local governments.

The paper argues that the budget process in its current form does not provide the basis for a stable equilibrium in the long run. In the first place, politicians at the national and sub national arenas do not have incentives to form credible -and durable- budget coalitions around the bargaining of budget allocations for public interest. In the absence of such coalitions, constraints through formal rules that impose conditions of discipline and austerity have proven useful in maintaining discipline in the short run. Not surprisingly, the congress and the president have recently voted to abolish key aspects of a Fiscal Responsibility Law to allow for greater spending during an electoral campaign year. The other cause for instability in the long run is that rising oil prices have increased the rent seeking incentives of politicians, included the president. As a result, oil stabilization funds originally created to benefit from oil revenues and sustain dollarization efforts, have been further earmarked with projects of short term interest.

The paper structure is as follows. The first part provides a brief characterization of the economic and political background of Ecuador in the last three decades. The second part offers a theoretical overview of existing literature, the proposed dimensions of budget outcomes and the variables of interest. The next section identifies two critical moments of change in the Ecuadorian budget process: the 1998 Constitutional reform and the 2000 move to dollarization.

Sections 4 and 5 describe the formal stages of the budget process in Ecuador and analyze the roles of the main budget players on the budget process. Section 6 empirically tests the impact of constitutional reforms and economic dollarization on the quality of budget outcomes. Section 7 summarizes the main findings and concludes.

1 Background

The policymaking process

The Ecuadorian policymaking process is characterized by a permanent tension between a very strong agenda setting player (the president) and multiple veto players who are active in the national legislature, the sub national governments, organized interest groups and the streets. This perverse configuration of diverging interests and actors with few formal incentives to support government coalitions over the long run, has gained the country a reputation of being "a very difficult country to govern". In the last decade alone, high levels of ethnic and regional conflict, military (in)action, economic decline and congressional deadlock played at different times a contributing role in the demise of three presidents before the end of their terms.[1]

Earlier research suggests that presidents have at least two alternative options when promoting policy change. The first one is to submit legislation to a highly fragmented and contentious national legislature. But evidence shows that presidents, despite having strong constitutional powers to legislate including the ability to decree legislature, have obtained poor success rates in a legislature where they have lacked –single party- congressional majorities in more than seven decades. In average, only 30% of the presidents' agenda gets approved by congress, one of the lowest in the region (Mejia Acosta 2006). Policy deadlock or rigidity is due to several factors, including of course, political fragmentation, but also the lack of formal incentives to form and sustain coalitions. Political fragmentation results from a very permissive and badly apportioned electoral system which has allowed for the proliferation of multiple political parties. Additionally, the presence of local *caudillos* and charismatic party leaders has further polarized the political arena by appealing to existing ethnic and regional divisions. Ecuadorian politicians have also lacked the formal incentives to sustain multiparty coalitions. The existence of legislative term limits for the most part of the current democratic period, created rent seeking politicians who lacked long term ambitions. In average, no more than 14% of legislators sought and obtained reelection in congress between 1979 and 1995 (Mejia Acosta 2006). Term limits also eroded the value of coalition incentives. Opposition parties perceived that participating in a government cabinet may become an electoral liability in the next round of elections if the government fails to pass reforms. But the fear of failure became a self fulfilling prophecy as parties and legislators had greater incentives to disband or deny any government collaboration as new elections approached. Instead, governments and legislators preferred to assemble ad hoc ghost alliances by trading pork barrelling projects, distributing resources and patronage to constituents, making particularistic policy concessions, granting personal favors, etc, in exchange of legislative support (Mejia Acosta 2006). The overall effect was a highly ineffective and costly bargaining process that produced very little policy change.

[1] Not all factors contributed to political instability. For example, economic recession was a key factor leading to Mahuad's ousting, but not in the case of Gutierrez', which occurred in a period of economic growth.

The second avenue for policy change has been to delegate and empower a decisive technocracy or bureaucracy to carry out reforms by marginalizing political parties in the legislature. These executive-sponsored bodies such as the Monetary Board, the Central Bank, or the National Council for Modernization, enjoyed much discretionary power to produce policy change, and were often able to produce decisive policy changes. The downside to this route is that such policy changes were directly linked to the interest groups participating of the decision making process and policies were undone or frequently revised every time a new government came into place or even within the same administration. This pattern of policy volatility is best illustrated by the adoption of at least nine exchange rate regimes prior to the dollarization of the economy in 2000 (Mejia Acosta et. al. 2006). Insulating the decision making process from a highly fragmented political environment was not a stable equilibrium either and directly or indirectly, legislators and shifting political alliances contributed to high turnover rates of key cabinet ministers and decision makers. Evidence shows that the average mandate of a Finance minister was approximately 12 months (Mejia Acosta 2006).

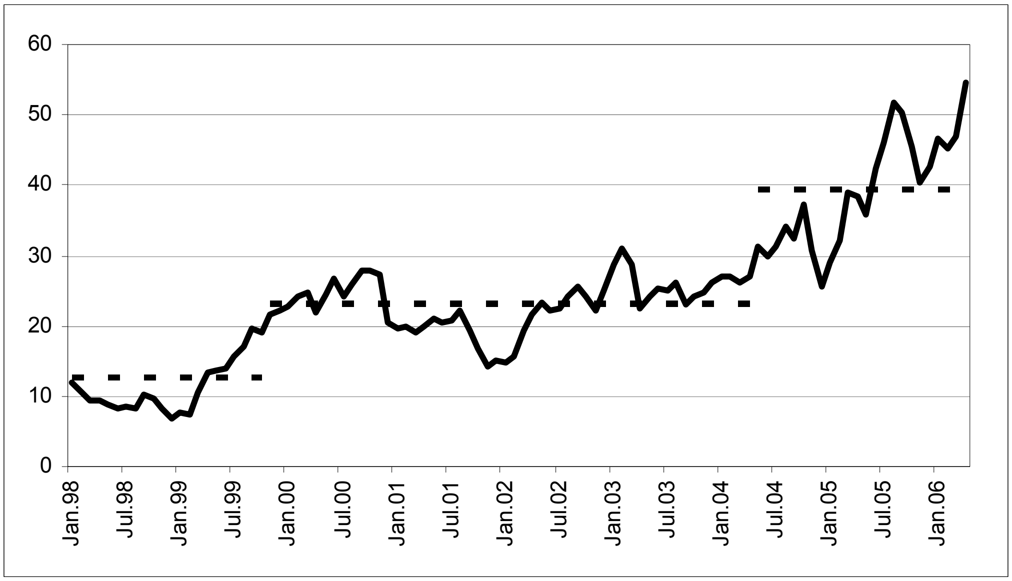
At both ends of this convoluted policymaking process, a set of formal and informal "last ditch veto players" played a dramatic role to oppose, stall, or revert policy decisions that were not found acceptable. The formal players are often made of disgruntled party members who have for instance, appealed to a judicial review of the supreme courts, or the Constitutional Tribunal, to challenge and stall the implementation of a law that passed through a congressional coalition or a technocratic body. Non conventional policy players included the indigenous, the military, popular groups who took to the streets to oppose adopted changes, and to challenge the legitimacy of the regime as a whole, as illustrated by the popular revolts that led to the ousting of presidents Bucaram, Mahuad and Gutierrez.

The oil factor

Oil is Ecuador's main export and its primary source of fiscal revenues. Between 2000 and 2005, oil revenues were, on average, 26.4% of non-financial public sector revenues and 35.1% of central government revenues. Given the high dependence of public revenues on oil exports, the Ecuadorian economy is particularly vulnerable to fluctuations in the world price of oil (Fernandez and Lara, 1998) or other natural disasters that may affect the steady supply of oil (such as the 1987 earthquake that broke the oil pipeline). An interruption in oil revenues could rapidly trigger a fiscal crisis. This vulnerability explains in part the country's poor or unstable economic performance during the last democratic period. The underlying premise is that fluctuations in oil prices also affect the impact of institutional variables on the budget policy-making process, as well as the incentives to fiscal discipline available to budget players.

During the years 1998 to 2005, which are also the main focus of this document, three different periods can be identified in the trend of variation of Ecuadorian oil prices (see figure 1). The first period is between January 1998 and October 1999, when prices remained low, at an average of \$12.6 per barrel. The second period occurs between November 1999 and April 2004, when prices increased to an average of \$23 per barrel. Lastly, during the third period -between May 2004 and April 2006- they rose to an average level of \$39.1 with an increasing trend

Figure 1: Monthly oil prices and period averages
(US$ per barrel of Ecuadorian oil)



Source: Central Bank of Ecuador

The periods that characterize the evolution of oil prices are consistent with the general pattern of variation in fiscal outcomes. Table 1 illustrates that variation in oil prices can also be mapped unto three periods of fiscal performance between 1998 and 2005. During the first two years (1998 and 1999 and largely to low oil prices), the budget has large deficits. Then, between 2000 and 2004, the deficits are reduced and the net balance is actually positive, partly due to higher oil prices. During this short period -with oil prices remaining relatively stable (see figure 1)- the non-oil deficit also decreased from 7.7 to 4.4% of GDP, partly thanks to the constraints imposed by dollarization and later reinforced by the Fiscal Responsibility Law (FRL). In other words, even when oil prices became stable, they still caused a positive impact on other budget factors that contributed to an overall improvement of fiscal outcomes.

Table 1. Evolution of fiscal results
(relative to the non-financial public sector and in percentage of GDP)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Budget global deficit	-5.2	-4.9	1.5	0.0	0.8	1.1	2.1	0.7
Non-oil deficit	-9.1	-11.2	-7.7	-6.3	-4.8	-4.7	-4.4	-5.4
Total revenues	17.3	21.1	25.9	23.3	25.6	24.1	24.8	25.2
Oil revenues	3.9	6.3	9.2	6.4	5.6	5.8	6.4	6.1
Non-oil revenues	13.4	14.8	16.7	17.0	20.0	18.3	18.4	19.1
Expenditures	22.5	26.0	24.4	23.3	24.7	23.0	22.7	24.5

Source: Central Bank of Ecuador

In 2005, the net positive balance of fiscal accounts decreases in magnitude and the non-oil deficits experiences a rise. This is consistent with a reversion of the trend that had been observed in the earlier years and after dollarization. It is in this year where there is a shift in economic policy through a legal reform that de facto eliminated the limitations to the expansion of public expenditure that were determined by the FRL. This event occurs when oil prices reach their highest level (see figure 1). This legal reform is voted by the same political parties who, three years earlier, had approved the original draft of the FRL. This is suggestive evidence of changes in preferences and behaviors of the actors of the budget PMP that are closely related to movements in oil prices.

Given the contentious nature of the policymaking process and the high dependency on oil revenues, Ecuador has not demonstrated a capacity to adapt to shocks (policy rigidity), nor has improved its ability to sustain agreements over time (policy volatility). Fiscal policy is set within a complex frame, where the budget plays an important role, not only because of the magnitude of the resources it allocates, but because of its rigid structure due to earmarking. A rigid budget imposes one additional constraint to the capacity of fiscal policy to adapt to external shocks. This constraint is enhanced with the adoption of dollarization which *de facto* limited the range of adjustment instruments available to the executive. The windfall effect of rising oil revenues can temporarily alleviate the fiscal rigidity imposed by dollarization, but this factor does not replace the need for deeper structural reforms. During the last thirty five years, the inability to make necessary fiscal reforms has been one of the elements hindering the success of adjustment programs (Hurtado, 2006).

2 Theoretical Framework

This section outlines the main theoretical and empirical implications of studying budget outcomes, discusses four dimensions associated with this concept and their tradeoffs, and outlines existing explanations found in the specialized literature.

2.1 The Dependent Variable: the quality of budget outcomes

Following earlier work by Scartascini and Stein (2004), this section is interested in identifying a set of favorable or desirable characteristics of budget outcomes. Ideally, budget outcomes should be sustainable over time, they should produce highest long-run returns, they should reflect the preferences of the majority and they should be able to adapt to positive and negative external shocks. These characteristics are discussed below.

1. Sustainability

This feature seeks to find consistency between the costs of budget transactions with the inter-temporal budget constraint. This notion is measured in two ways:

a. Whether there is systematic and consecutive growth of the budget deficit over time compared to the growth of GDP, and
b. Whether the budget is heavily dependent on oil revenues vs. non oil revenues, and how this ratio evolves over time.

The evolution of sustainability of budget outcomes during the period of study is illustrated with cross-country data for the Andean nations, highlighting trends and discontinuities that are specific to the Ecuadorian case. Secondly, the paper uses secondary sources to document what others have identified was the positive impact of dollarization on fiscal sustainability.

2. Efficiency

This dimension explores the magnitude and direction of reallocation of resources during the budget process. It is organized in two parts.

a. The first part quantifies the magnitude of spending reallocations across items at different stages of the budget process (Scartascini and Stein 2005) and it identifies whether significant changes in the magnitude of spending reallocation are at all related to the instances of political and economic reform studied in this paper. The underlying assumption is that budget processes characterized by large and constant spending reallocations are more likely to be inefficient in that they prevent medium-term expenditure planning and introduce uncertainty in the institutions whose operations rely on the budget.
b. The second part explores the evolution of the efficiency of public spending in basic education, as a case study. By focusing in one particular sector, it is possible to look at specific variables that are indicative of how efficient (in an economic sense) was the allocation of resources in the sector.

3. Representativity

This dimension measures whether expenditure allocation reflects preferences of population at large or benefits private interests. These changes are assessed in two ways:

a. By looking at changes in per capita provincial spending, controlling for disparities in poverty and population (poverty rates vs. number of poor),
b. These budget outcomes are related to critical changes in the electoral system that altered the fundamental of territorial representation (one person, one vote) during the period of study.

4. Rigidity vs. flexibility

This dimension explores the extent to which existing budget allocations reflect long term political agreements between different budget players (budget coalitions), or whether they result from short term and non-cooperative allocation of resources ("hardwiring") that leave budget players with very little space to adjust to unexpected circumstances. In the Ecuadorian context, this is done by explaining the composition of budget rigidities (earmarks) on the revenue side as well as on the expenditure side. A brief discussion follows on the role played by increasing oil revenues and its impact on the likelihood of obtaining long term cooperation.

2.2 The Determinants of Budget Outcomes

Budget outcomes are determined by factors such as the number of actors in the budget process, their level of influence, the rules of interaction between them, the number of instances of interaction, the present value of the benefits from cooperation, and the enforcement mechanisms. While a particular change along one of these independent variables may improve certain characteristics of budget outcomes, they may have the opposite effect on others. This section identifies three sets of variables affecting budget outcomes: changes in the incentives of budget actors, changes in the configuration of budget institutions, and external shocks.

Changes in the incentives of political actors

The existing literature broadly distinguishes a set of political institutions that would contribute to centralizing the budget process, thus contributing to more disciplined and sustainable budget outcomes (Alesina and Perotti 1999; Hallerberg and Marier 2004; Scartascini and Olivera 2003). Among these variables are:

- a stronger presidential mandate
- stronger presidential prerogatives to initiate budget
- higher reelection rates of legislators and/or longer time horizons of politicians
- lower number of parties overall or higher number of parties represented in the budget coalition
- lower levels of ideological polarization
- greater electoral proportionality, in territory and electoral formula
- limited decision making process in legislative committees
- the timing of the electoral cycle (proximity to next election)

Changes in budgetary institutions

Similarly, existing works have illustrated how specific budget rules that account for a more hierarchical budget process may contribute to greater fiscal discipline (Alesina et. al. 1999; Scartascini and Filc 2004, Samuels 2003). These include:

- a greater level of centralization of the budget making process in the hands of the executive
- the presence of caps on expenditure or constraints to limit the congressional ability to generate new spending lines
- the elimination of off budgetary items
- a greater level of budget transparency

Changes in economic conditions or exogenous shocks (that in theory would encourage more/less cooperative outcomes):

Finally, there is a set of changes in economic conditions that may alter incentives for political cooperation or directly affect budget outcomes. For the Ecuadorian case, relevant events in the period we will study are:

- Dollarization
- Changes in oil prices

3 Critical Moments in the Ecuadorian Budget Process

Over the past three decades, Ecuador has witnessed a wide array of endogenous and exogenous changes that theoretically and empirically have had a significant impact on the design, approval, execution, and control of the budget process. Constitutional changes approved in 1983, 1994-1998, and 2000 affected the composition, time horizons and incentives to cooperation of political actors. Others have directly affected the rules of the budget process itself, including the approval process, the allocation of expenditures, fiscal responsibility, oversight, and control mechanisms. Table 2 outlines which were the most relevant changes that constitutional reforms and dollarization imposed on political institutions and the rules of the budget process itself. The next section explains how a reduction in the number of the relevant budget players, the changing ambitions of political actors, the expansion of time horizons, the lack of coalition currencies, the frequency of interactions and the existence of monitoring mechanisms altered the quality of budget outcomes in Ecuador.

Table 2. Critical moments and hypothesized effects on cooperative budget outcomes in Ecuador

	Constitution 1998	***Dolarization 2000 (and LRF)***
Sustentability	[more]: longer political horizons	[more]: lack of monetary policy adds rigidity to fiscal policies LRF – greater incentives for fiscal discipline
Efficiency	[more]: Executive has greater agenda setting power	[more]: LRF introduces greater visibility/ accountability for budget execution
Representativity	[more]: greater proportionality of political representation	
Adaptability	[less]: Constitution earmarks taxes end expenditures	[more]: lack of monetary policy should induce some flexibilization of budget

3.1 The 1988 Constitution

The National Assembly that produced a new Constitution between 1997 and 1998 was inspired by the need to strengthen political institutions that promoted increased governability and improved political representation. In practice, the approved reforms strengthened presidential powers over congress (governability), *while at the same time* aiming to strengthen the connection between citizens and politicians (representativity). Together with other closely related reforms, these reforms introduced a mixed set of incentives for political cooperation.

In the first place, reforms increased the level of influence of the president in the budget process, at the expense of legislators. Presidents were granted exclusive rights to initiate the process and their decree and veto powers were increased. Congress was banned from increasing expenditures or creating new revenues, and legislators were no longer allowed to bargain provincial allocations or discretionary -off budget- funding for their districts, but rather approve budgets based on sectoral spending (*partidas de gasto*).[2] Secondly, reforms sought to reduce the number of actors participating in the budget process. The number of legislators was reduced from 123 to 100. After 1998, congress became more provincially oriented; as provincial legislators were elected through a personalized vote and the figure of national legislators (elected

[2] This occurs after a 1995 plebiscite.

on a national slate) was abolished. Internally, the seven-member budget committee gained greater agenda setting power to revise the executive's proposed budget, but the decision making power for budget approval was devolved to the entire congressional floor. Lastly, reforms extended the temporal horizons of budget players. Legislators were allowed to seek reelection since 1996 and their mandate was extended from two to four years (thus eliminating mid-term elections). Legislative appointments and committee service was also extended from one to two years. In theory, this should have had contributed to expanding the legislators incentives for making inter temporal agreements, since legislators were appointed for longer periods in congress while they accumulated more experience over time.

In practice, the 1998 Constitutional reforms produced a perverse combination. On the one hand, the increased budget powers of the president made him less dependent on gathering legislative support for budget approval and it strengthened his ability to execute budget allocations. Legislators in turn, gained greater political representation vis-à-vis their constituents (they enjoyed longer terms in office with no term limits, and were elected by personalized voting), but had lost their ability to access to investment projects for the benefit of their constituencies. This combination severely hindered politicians' prospects for developing an "electoral connection" with their voters. Concurrently to the drying out of coalition incentives at the national level, a series of institutional reforms strengthened the abilities of local governments to become successful lobbyist in the budget process and develop a successful electoral connection with voters. The trends and empirical evidence of this shift are properly discussed in section 5 and 6. Suffice here to say that traditional political parties who lost their influence on the national budget process, reappeared as crucial actors in a new policy arena: the sub national governments.[3]

3.2 The 2000 Dollarization

The governments' decision to dollarize the economy on January 2000 came as a drastic response to contain or at least mitigate the effects of a financial crisis that threatened with hyperinflation, a stagnating economy (with GDP going down by 6.4% on 1999), falling world oil prices, and a generalized disbelief in the governments' ability to produce economic recovery. A positive effect of dollarization is that it brought inflation down to levels that the country had not experienced in over two decades and provided economic agents with signals of stability that had been very much sought after. Dollarization formally reduced the possibility that the devaluation-inflation cycle eroded the real value of budget allocations. By bringing economic stability dollarization decreased the discount rates of economic agents.

By renouncing to monetary policy, the government gave a strong signal of its commitment to a structural reform in the hopes of stabilizing the economy and recuperating some credibility at home and abroad. In terms of the budget process, the drastic change to dollarization eliminated one of the policy arenas where presidents did have some discretionary power to adopt and resoluteness to carry our policy decisions.[4] By renouncing to monetary policy, dollarization

[3] A brief description of all the changes that have been made on the budget's legal framework can be found on Table 3, at the end of the section 4.

[4] After the 1998 Constitution, the Central Bank had recently undergone a reform that increased its independence. The Central Bank had been under intense political pressure to rescue the private financial institutions that were at risk during the crisis. These institutions were - at large - from the Coastal region. It is not by chance that the economic sectors that proposed - and finally succeeded- the adoption of dollarization were also from the Coast (See Mejia Acosta et. al. 2006).

reduced the number of policy instruments available to the economic authorities, thus imposing an additional burden of responsibility over fiscal policy.

In the aftermath of dollarization, and while the country was still paying the economic price of the financial crisis, many government policymakers as well as development banks favored the adoption of reforms that would secure responsible fiscal management. Policies like the adoption of a Fiscal Responsibility Law and the creation of an oil fund - that reveal a change in the inter-temporal preferences of agents- took place in the years following dollarization and were consistent with a change in agents' discount rates and with higher public-regardedness of the benefits of sound fiscal policy. Additionally, the adoption of dollarization brought transparency to public accounts. In the past, public balance sheets had a line item called "exchange rate adjustment" under which –in theory- adjustments due to exchange rate fluctuations could be recorded. In practice, this account could mask small or not-so-small allocations that were accountable to no one. De facto, dollarization eliminated this and other incentives for speculation with the exchange rate.

4 The Budget Process

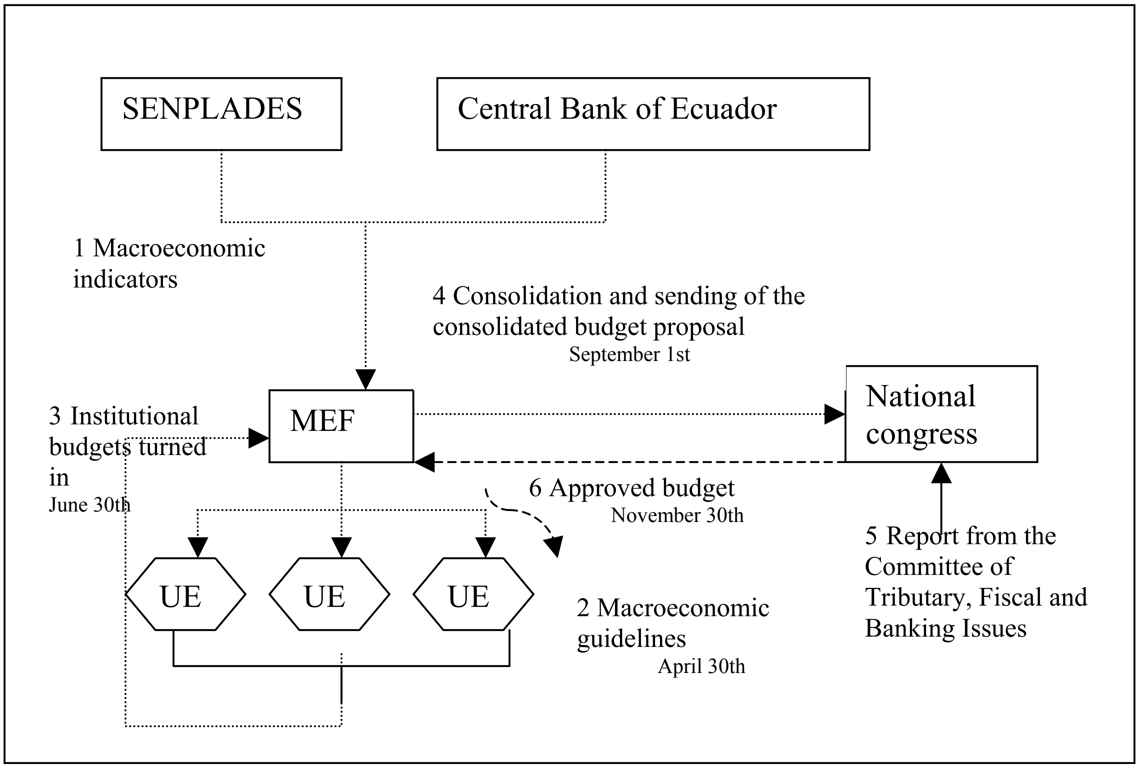
This section briefly analyzes the formal budgetary process in Ecuador. The end of the section outlines the most relevant reforms operated in the past decade, including a brief description of the budget process before and after the reform and its proposed outcomes. The actual workings of such institutional changes are discussed in the next section.

The fiscal year begins on January 1st and ends on December 31st of the same year. The Executive branch starts the budget cycle in May each year through the Ministry of Economy and Finance (MEF) by sending the budgetary guidelines established by the MEF to the Executing Units (UE). The Executing Units can report back to the MEF their budget estimations until June 30th each year. The president of the Republic sends the information gathered by the Ministry of Economy and Finance to National congress until September 1st. Congress evaluates and issues a report on the matter until November 30th each year (see Figure 1), with the exception of the years in which a new president takes office, when the budget is presented until January 31st and approved until February 28th. Meanwhile, the budget from the previous year is still in effect.[5]

All resources than have not been fully executed by the Executing Units during the fiscal year, are given back to the MEF at the beginning of the next fiscal year who then returns them to the Unique Treasury Account.[6]

[5] Political Constitution, Art. 258.
[6] MEF website, SIGEF terminology. An Executing Unit will be understood as the administrative unit (organizations or groups) that executes an assigned budget.

Figure 2: Formulation and budget approval



Source: MEF, valid regulations. Authors' elaboration

The budgetary process is made up of four stages: formulation, approval, execution and budgetary control.[7]

4.1 Formulation Stage[8]

The public sector's budget is comprised of the Non Financial Public Sector budget, which includes the General Government Budget (GGB); the public enterprises, sectional governments, and special funds budgets; and the Financial Public Sector budget, as in Central Bank and other public financial institutions. The main participants in the stage of budget design are: i) the president of the Republic; ii) the National Planning Office (SENPLADES); iii) the Executing Units; iv) the Ministry of Economy and Finance; and v) the Central Bank of Ecuador (BCE) (see Figure 2).

The main actor in regulating the public sector's budget formulation and the responsible of elaborating the GGB proposal is the Executive branch through the Ministry of Economy and

[7] Public Sector Budget Law, 1992.

[8] The budget replicates the previous years', adjusted by inflation, but it would be interesting to analyze cases in which economic growth is different from inflation. The Ministry of Economy and Finance (MEF) and the middle ranks of the bureaucracy have a significant decision-making power that has not been properly explored by literature. Some relevant questions at this stage are whether MEF officials in charge of the budget design are career bureaucrats or political appointees that change with every government, and whether the Central Bank plays any significant role in sharing technical expertise to compensate for the lack of planning capacity of the MEF.

Finance. The MEF begins the budgetary process with the presentation of the National Development Plan, which gathers the national guidelines and policies established for each fiscal year, and the macroeconomic indicators handed by the Central Bank of Ecuador.[9] Based on the information obtained from the SENPLADES and the BCE the MEF hands in the macroeconomic guidelines to the different Executing Units (UE) until April 30th of each year[10] for them to develop their budgets. In accordance with the fiscal responsibility principles,[11] the Law establishes that the MEF can not present a budget proposal with a Non-Financial Public Sector deficit higher than 2.5% of the Gross Domestic Product for that year. Outlays destined to cover current expenditure in the GGB can not increase more than 5% of total inflation registered in the previous year.[12]

The Executing Units elaborate their budget estimations based on the annual financial needs for plans and regional and institutional programs that entities and organizations of the public sector require.[13] The MEF, through the technical experts[14] in the Sub-secretary's office of Government Accountability and the Sub-secretary's office of Budgets respectively, centralizes the regulations, analyzes and consolidates the budgetary information sent by the UEs considering budgetary ceilings and restrictions related to regulations established by law. The fiscal budget is mainly made up of salary and wages, maintenance, and basic services expenditures, categories that are indexed to inflation and represent an inertial amount in the elaboration of the GGB.[15] The UEs turn in their information through the SIGEF system until June 30th each year. Any additional investment requirements have to be previously approved by the SENPLADES, and their financial viability has to be certified by the Sub-secretary's office of Public Investment.[16] The MEF analyzes the collected information and before consolidating it, verifies compliance with the macro-fiscal rules by the UEs. If the macro-fiscal rules have not been accomplished, the MEF can amend the information.

Once the information is consolidated, the Executive has until September 1st to send the budget proposal to congress for their analysis and approval.

4.2 Approval Stage

The National congress has the prerogative to approve the General Government's Budget, and ensure its proper execution.[17] The main participants in the budget approval stage are: i) the floor or *Pleno* of National congress, ii) the specialized congressional committee, iii) the Ministry of Economy and Finance, iv) the technical experts that represent the state's recollection, execution and control units (see Figure 1).

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[9] Political Consitution, Art. 258. Interview #1, BCE technical experts (those who are career bureaucrats) work in coordination with the Sub-secretary's office of Economic Policy of the MEF before handing in the macroeconomic indicators.
[10] Fiscal Responsibility, Stabilization and Transparency Law, Art. 33.
[11] Public Sector Budget Law, Art. 4.
[12] Added through Art. 60 of the 2000-4 Law, O.R. 34-S, March 13, 2000.
[13] Public Sector Budget Law, Art. 11.
[14] MEF, career bureaucrats with technical expertise.
[15] Almeida María Dolores, Gobernabilidad Fiscal en Ecuador, July 2005.
[16] MEF, Sub-secretary's office of Public Investment, Methodology for Ranking Investment Projects.
[17] Political Constitution, Art. 130.

The president of congress receives the budget proposal from the Executive. According to the legal mandate, "the president of National congress will send to the correspondent Committee each project of law for its study and will later inform on it".[18] Even though there is no explicit disposition that confirms it,[19] the committee in charge of the revision of the budget proposal is the Committee of Tributary, Fiscal and Banking Issues.[20] The Committee is in charge of delivering to the *Pleno* of congress a detailed report on the proposal sent by the Executive.

Specialized permanent committees are made up of seven principal members and their deputies, who assume their functions for a two-year period and can be reelected.[21] No alternate congressman can be principal or deputy member of a committee. During the stage of budget proposal analysis, the specialized committee asks for information and opinions from the different governmental entities, either at the income level through the Internal Revenue Service (SRI) or at the expenditure level through the different Executing Units. The specialized committee writes up a report with observations and general guidelines about the budget proposal, which is turned in to the president of congress, who then puts it in the official agenda for its debate in plenary session. In Ecuador, there is no congressional Budget Office that can make its own estimates and forecasts of the fiscal situation.

During the plenary session, the president of the specialized committee presents the report in the *Pleno* of National congress. Legislators can ask for specific changes to the proposal based on the general guidelines established in the report from the specialized committee. As one of the attributions exclusive of the Central Bank's board of directors, it can inform congress of the existent limits on public indebtedness.[22]

Once the report is issued, congress has until November 30th each year to approve or reform the proposal, which is discussed in only one debate, by income and expenditure sectors. If until such date the budget is not approved, the proposal, as elaborated by the Executive, becomes valid.[23]

4.3 Execution Stage

The Political Constitution establishes the Executive branch, through the MEF, as the responsible of executing fiscal policies. The main players in the budgetary execution stage are: i) the Sub-secretary's office of Budgets, MEF, ii) the Nation's Treasury, MEF, and, iii) Executing Units.

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[18] Ecuadorian National congress' Law, Art. 39.

[19] 1998's Constituent Assembly eliminated from the constitutional text the list of specialized congressional Committees in which the Committee of Tributary, Fiscal, Banking and Budget Issues was in charge of studying and informing on the budget proposal.

[20] The Committee of Tributary, Fiscal and Banking Issues is responsible for the elaboration of reports on the projects of law related to taxes, fees and contributions; the private and public financial system; the customs system; public control entities such as the General Comptroller's Office, Superintendences, and Central Bank. In practice, no other committee deals with fiscal issues.

[21] Ecuadorian National congress' Law, Art. 31. Reform introduced by the 1997 Constituent Assembly. See Table 3.

[22] Idem. Art. 263.

[23] Political Constitution, Art. 258. This change is introduced in 1996, after a plebiscite in 1994 (the first plebiscite called by Durán-Ballén) took away from legislators the possibility of negotiating resources directly. The questions/answers in the plebiscite were: i) Question 3. Should legislators be able to manage fiscal budget funds? No. ii) Question 4. Should legislators approve the State's Budget by expenditure sectors or budgetary entries? Sectors. See Table 3.

Once the GGB is approved by congress, the MEF ensures that it complies with the fiscal responsibility principles. The Sub-secretary's office of Budgets and the Nation's Treasury are in charge of transferring the approved resources to the UEs.

The Executive branch, through the MEF, nonetheless, has the attribution to modify the approved GGB,[24] given that as is established by Law, the rules of transfers, increases or reductions and other budgetary modifications are established by the Ministry of Economy and Finance.[25] The MEF receives and approves the requests for resource transfers from those responsible of cash programming in the UEs, which depend partially or totally from the GGB, based on the information of their inflows, payment of obligations and financing disbursements.[26]

The budgetary execution is marked by the budget's financing, its source of origin and the frequency of cash entry. There is often a lack of coordination between revenues and expenditures due to the timing and volume of revenues from tax collections and their execution schedule because revenues from income taxes are higher in April while current expenditures in the GGB are constant.[27] This situation has established a priority order in the transfer of resources towards those UEs responsible of budgetary execution. Additionally, the MEF can adjust the correspondent cash programming based on the spending capability of the UEs.[28]

The priority order is directly related to the budget structure by expenditure accounts and is applied when the effective, current non-oil revenues in the GGB are less than what was budgeted for the quarter.[29] The Ministry of Economy and Finance can amend allocations in the expenditure budget, including to transfers and participations, in the same amount of those revenues that were not obtained. These amendments can not affect those allocations determined by the Constitution. In the event that amendments are made to investments, they have to be subject to prioritization according to the multi-annual plan of government and to the hierarchy of the projects that are being carried on by the Executive.[30]

4.4 Control Stage

The follow-up and control of the budgetary execution is responsibility of the General Comptroller's Office (through the system of control, censuring and auditing of the State), and National congress.[31] The Ministry of Economy and Finance also plays a role in budgetary control.

During the fiscal year, the MEF analyzes the budgetary execution of the UEs and, in the event of considering it necessary, can adjust the correspondent cash programming.[32] The system of

[24] Public Sector Budget Law, Art. 54.
[25] Fiscal Responsibility, Stabilization and Transparency Law, Art. 41.
[26] Public Sector Budget Law, Art. 27.
[27] SRI, tax collection statistics 2000-2005.
[28] Public Sector Budget Law, Art. 27.
[29] Interview #2.
[30] Fiscal Responsibility, Stabilization and Transparency Law, Art. 41.
[31] Political Constitution, Art. 258.
[32] Public Sector Budget Law, Art. 27.

control, censuring and auditing of the State[33] has two components: i) internal control, and ii) external control. The UEs have to ensure the creation and maintenance of their internal control system, through which public servants and functionaries report on and make themselves responsible for the execution of their attributions, the use of public resources and the results obtained.[34] The internal control exercise has to be applied before, during and after[35] through the specialized units in each of the UEs, which have to comply with the valid regulations established by Law.

External control is exercised by the General Comptroller's Office and National congress, being the active participant the General Comptroller's Office. Even though there is a constitutional mandate for National congress to follow-up on the budgetary execution, in practice it has no technical capacity to do it. The participation of the General Comptroller's Office is ex-post the budgetary execution; therefore, timely alerts on the execution and quality of expenditure of the UEs have to come from the internal control. It is worth mentioning that the large number of UEs makes it impossible for the General Comptroller's Office to exercise external control on all of them systematically.

The following table sums up the main formal reforms to the budgetary process in the last decade:

Table 3. Main institutional reforms to the budget process (1994-2002)

Reform	Legal Body	Before	After	Effect
Elaboration				
Multi-annual Plans	Fiscal Responsibility Law (2002)	No	Approving multi-annual plans becomes a requisite	Improves budgetary planning
Fiscal Responsibility	LRF, Art. 60, R.O. 34-S, 13-III-2000, which adds an article after Art. 4 in the Budget Law	No	Principles of fiscal responsibility, sustainability, transparency, conservativeness and equilibrium are introduced	More fiscal discipline
Approval				
Procedures to approve the Committee's report	Constitutional Reform (1998)	The report is voted by the *Pleno* of the committees (35 members)	The report is voted by the *Pleno* of congress (100 members)	Centralizes the revision power of the Committee, but disperses the costs of approval
Approval of expenditure categories	Constitutional Reform (1994 plebiscite)	By budget entries	By sectors	Costs of transactions increase

[33] General Comptroller's Office Law, Art. 6.
[34] General Comptroller's Office Law, Art. 5.
[35] General Comptroller's Office Law, Art. 12.

Reversal Point	Constitutional Reform (1998)	No consequence was established in case congress did not approve the budget until December 31st	If congress doesn't approve the budget until November 30th, the budget proposal presented by the Executive becomes valid	More agenda power for the Executive
congress' revision power	Constitutional Reform (1998)	Was able to create unbudgeted expenditure as long as the correspondent financing was created	Can not modify the total amount of revenues or expenditures in the budget	More fiscal discipline
Local governments indebtedness	LRF (2002)	No limits	Assigns limits to indebtedness and debt payment	More fiscal discipline
Execution				
Existence of reserved expenditures	Constitutional Reform (1998)	Yes	No, with the exception of Defense	Less discretionality from the Executive
Earmarks	Sectional Governments' Law -1997	Legislators were able to manage funds of interest to provinces, and MEF	15% of the GGB is assigned to provincial councils and municipalities for investment projects or plans	Less discretionality from the Executive

Source: Valid regulations, CORDES. Authors' elaboration.

It is worth noting that the sequence of fiscal reforms reflected many conventional beliefs about which institutions should strengthen the budget process, including for example, laws of fiscal responsibility, centralizing decision making authority through hierarchical budget institutions, and constraining the politicians' ability to handle discretionary budget allocations. As it will be illustrated in the next section however, such political discretionary power had been instrumental to forming policy coalitions in the fragmented Ecuadorian polity, thus the elimination of such incentives should have theoretically increased transaction costs.

5 The politics of the Ecuadorian Budget Process

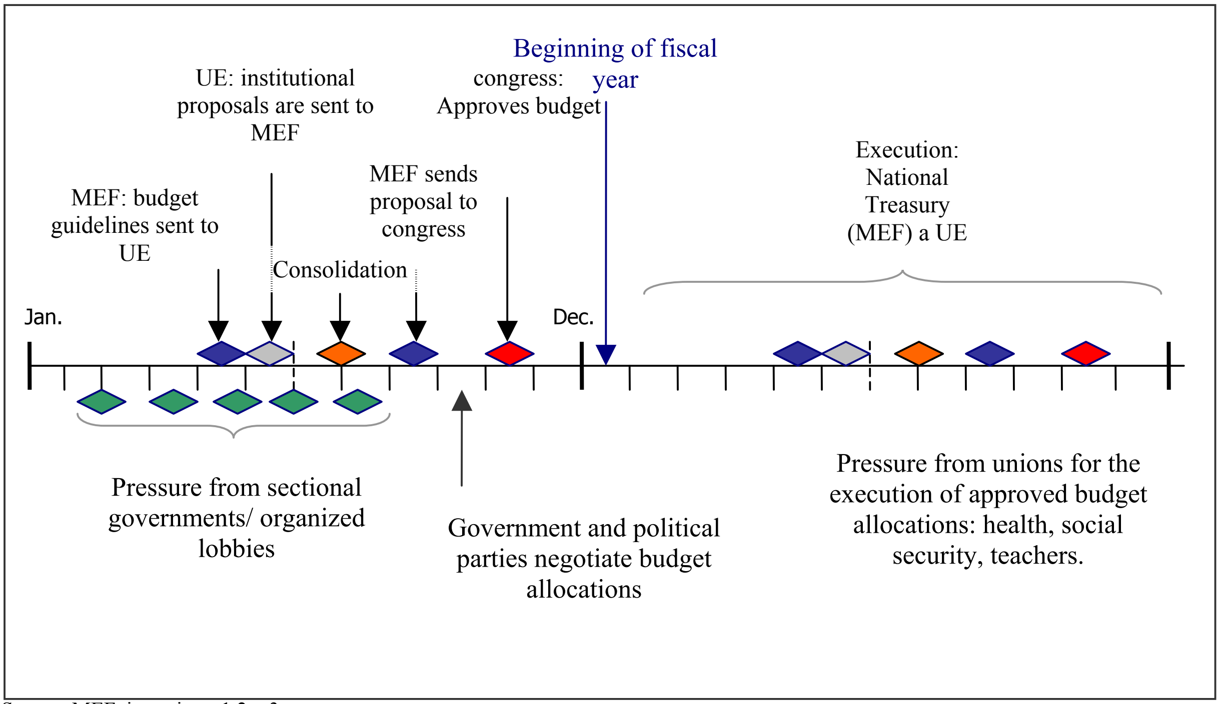
This section seeks to identify - at each stage of the budget process- the incentives that different budget players have to comply with, existing formal budget rules, and the extent to which actors produce alternative patterns of cooperation around most preferred policy outcomes. The Ecuadorian budget process illustrates a case where the adoption of stricter budget rules to enforce greater fiscal discipline after the 1998 constitutional reforms and the dollarization process, did produce favorable budget outcomes but at the price of dissolving political incentives to sustain longer term coalitions.

The general overview of the Ecuadorian policymaking process highlighted several institutional impediments to the formation of political coalitions, including the social and political fragmentation of actors, the existence of term limits and the eroding value of coalition incentives. For the most part, such factors have also remained present in the budget process even after the adoption of constitutional reforms that expanded the time horizons of policymakers. In general, reforms strengthened the agenda setting role of the president at the expense of marginalizing legislative actors from the budget process. In theory, it was expected that presidents could impose and apply fiscal goals without having to form costly legislative alliances. Furthermore, political incentives to assemble and sustain government coalitions were dismantled, as legislators were no longer able to bargain budget allocations for provincial interest or access discretionary funds. In practice, some of the distributive conflicts over budget allocations were translated to the sub national arena, where provincial and municipal governments have gained greater access to earmarked resources (up to 15% of government spending) and have successfully lobbied for other sources of government spending.

At the margins of the budget process, and consistent with the portrayed role of last ditch veto players, less powerful and organized political actors including labor and teaching unions, have taken to the streets to demand greater spending or effective execution of approved allocations. Figure 3 maps the influence of the main political actors and lobby groups. The colored diamonds indicate the formal and informal instances in which political actors may influence (or puncture) the budget process. We identify three types of budget actors: 1) decisive players who have the formal or informal power to influence in policy formulation (i.e. the executive, business lobbies, local governments), 2) veto players whose cooperation is needed to adopt policy changes (i.e. the legislature, political parties), and 3) last ditch veto players who may exert effective pressures to demand budget execution or revert unwanted policy decisions (i.e. courts, unorganized groups).[36] The next section explores the roles played by these actors in different stages of the budget process.

[36] These categories are not mutually exclusive and a budget player may have more than one role on the policy process, i.e. a city mayor may be a decisive player in budget formulation but can also mobilize constituents on the street and become a last ditch veto player to demand effective budget execution (see Mejia et. al. 2006).

Figure 3: Political timeline of the budget process



Source: MEF, interviews 1,2 y 3.

5.1 Executive initation

The executive branch in Ecuador has exclusive powers to initiate the budget process and it maintains a significant influence throughout budget execution as well. As it will be illustrated in this section, the overall balance of reforms adopted with the 1998 Constitution and dollarization have tended to strengthen the executive's agenda setting power over the budget process (both in the hands of the president and the Minister of Finance), while limiting or counteracting congressional influence.

There are three visible players interacting at this stage: the president who is the main agenda setter, the Minister of Finance who is an agent of the president in charge of liaising public sector's demands with technical criteria and constraints, and the Executing Units (*Unidades Ejecutoras*) that submit budget proposals to be considered in the General Budget. A fourth set of political actors, the sub national governments, have recently become influential players in the budget process.

5.1.1 The president

According to the Constitution, the executive is the sole responsible for initiating the budget process. presidents in Ecuador are elected by a run off system every four years and cannot seek immediate reelection. Between 1979 and 1996, the electoral calendar tended to produce "fiscally conservative" presidents at the beginning of their terms, who gradually relaxed their austerity ambitions as new elections drew near and legislative partners became more costly or more reticent to cooperate. In an attempt to counteract the electoral cycle, legislation approved in 1998 and 2002 introduced mechanisms for fiscal responsibility and long term planning.

In theory, the executive should have limited space for maneuver since more than 90% of the budget is earmarked. In practice, the president has used his agenda setting power and technical capacity –plus the fact that congress lacks a congressional Budget Office to verify or replicate fiscal forecasts- to underestimate revenues and overestimate spending when submitting a budget proposal. An important source of negotiation has been the extensive use of discretionary spending (*gastos reservados*) available to the president before 1998. presidents are believed to have used this item to mask political agreements without disclosing the nature and the magnitude of the transactions. But executive discretionality also led to corruption scandals that involved senior government officials using *gastos reservados* to buy legislative loyalties in congress, and to invest in sectional governments and education during the Durán Ballén, Bucaram, and Alarcón administrations. In 1997, a resolution of the General Comptroller imposed a ceiling on *gastos reservados*, which could only amount to 0.25% of the General Budget and limited its use to the Ministries of Defense and Internal Affairs.[37] A year later, the 1998 Constitution completely eliminated discretionary spending from the Executive to increase fiscal transparency and accountability.

5.1.2 The Ministry of Finance

During the formulation phase of the process, the Minister of Finance elaborates and sends the technical guidelines for budget formulation to the UE. He also aggregates and consolidates the proposed allocations into the General Budget for submission to congress. In consolidating the budget, the Ministry of Finance faces two types of requests: increases in recurrent spending and increases in capital spending. Pressures in favor of the former usually happen before the consolidation of budget information done by the Ministry of Finance and they usually come from groups such as teacher or doctor unions, pensioners, the military and the police, who request salary or pension increases.[38] Requests for increases in capital spending come, independently, from different sub national governments and begin in April[39]. Here it is both municipalities as well as provincial governments (or *Consejos Provinciales*) who lobby the Ministry of Finance. The actors with the strongest political presence and negotiation power are those from the largest provinces (Pichincha, Guayas, Azuay, and Manabí) and the largest cities (Quito, Guayaquil, and Cuenca) in population terms. These are also the actors who are most likely to succeed in their requests for increases in capital spending. The most influential representatives from sub national governments bring their requests directly to the president (see below), who ultimately delivers these messages to the Ministry of Finance. The demands from sub national governments and

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[37] "Límites a los Gastos". Diario Hoy, Quito. May 16, 1997. www.explored.com . The exact amount in 1997 was 50 thousand millon sucres.
[38] Interview #2
[39] Interview # 4. Local governments tend to increase their lobbying efforts towards April, which is the time of the year in which income tax revenues flow into government coffers.

their negotiation are more likely to succeed when their requests are included in the budget proposal *before* it sent to congress for approval.[40]

In practice, the Minister of Finance enjoys great discretionality during the formulation stage. Traditionally, between 1979 and 1996, the responsibility over fiscal policy was directly or indirectly shared between MEF, the Monetary Board, and the Central Bank. With the elimination of the former, the strengthening of the technical cadres of the bureaucracy at MEF, and the nominal independence of the latter after the 1998 constitutional reforms, more power and centralized decision making authority landed in the hands of MEF. This formal change of rules empowered MEF's role in the budget process, but in the eyes of the opposition, the Finance minister became a vulnerable political figure. Traditionally, MEF has been the most policy influential but also the least partisan and most volatile ministry in the government. Between 1979 and 1998, nearly 80% of all Finance Ministries did not have an explicit partisan affiliation. The Finance Ministry seemed to have been trapped in a cycle of instability. On the one hand, the government did not want to delegate technical economic policy making authority to party interests outside his own realm of control; but on the other hand, political parties had very few incentives to formally be part of a government coalition and wanted to avoid the policy and electoral liabilities of being called "*gobiernistas*" by other parties. Thus, parties had electoral incentives to publicly attack the workings of the Finance Minister, even if they benefited from government budget reallocations.

Like in a parliamentary system, MEF became a political fuse that was blown when a new executive-legislative alliance replaced an obsolete one, and a new minister –most likely another independent- was appointed in place. Between 1979 and 1998, the average tenure of Finance Ministers was 11.5 months in office (346 days) (Mejía Acosta et. al. 2004). The 1998 Constitution passed reforms shielding ministers from the danger of legislative impeachment and censorship, but reforms produced *the opposite effect*: the average tenure of the Finance Minister was reduced to 7.3 months (220 days) in the post-1998 period.[41] Ironically, the strengthening of the Finance Ministry after 1998 concurred with a greater volatility of ministers, as no Minister stayed long enough to formulate and execute the same budget[42]. Interestingly, most of the Ministers were ousted through their own resignation, not by congressional impeachment as it is commonly assumed.[43]

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[40] Interview #2. Even though Art.135 of the Constitution impedes legislators to negotiate, mediate or obtain allocations from the PGE, there are nevertheless prevailing lobbying mechanisms that seek to increase capital spending in the proposed budget.

[41] Calculated until December 30, 2005.

[42] More research needs to be done to properly model the interaction between the president and the Minister. In principle, a Finance Minister is a powerful and stable player provided that he is a perfect delegate of the presidents' authority. But what happens when the MEF diverges from the presidents' ideal position or most preferred interest? Ministerial instability could perhaps be better understood as an internal conflict of interests between the president and his own Finance Ministers.

[43] Between 1979 and 1998, only 3 out of 20 Finance Ministers were effectively impeached and censored by congress.

5.1.3 Executing Units

There are nearly 2.500 executing units[44], 80% of which belong to health and education sectors. In education, some units consist of: i) public schools (1.435); ii) rural school networks (196); iii) education units (61); iv) universities (27); v) cultural units CCE (22), among others. In the health sector: i) hospitals (43), ii) health centres by area (165), iii) provincial directorates (22), among others. Each unit submits its net budget proposal to MEF[45]. Given the large amount of submissions, MEF analysts cannot properly examine the content and validity of each proposed sectoral spending plan.

5.1.4 Sub national governments

Since the mid nineties, sub national governments have become one of the most influential players in the formulation process. Sub national governments comprise elected local authorities (or the *regimen seccional autonomo*) and president-appointed provincial governors. Elected officials include provincial prefects who preside over the provincial legislature made of provincial counselors. The 326 mayors preside over the municipal councils and, since 2000, local authorities are elected in off-years and they don't have term limits.[46]

The strengthening of local governments in Ecuador is due to the gradual transfer of greater resources, better technical planning, and increased legal responsibilities and prerogatives. The Association of Ecuadorian Municipalities (AME), a lobby group of mayors, received and channeled international assistance to strengthen the capacity and technical planning of local governments as part of the National Program for Municipal Development (PDM).[47] The AME also lobbied the government for greater resource allocation to intermediate and small local governments who had less bargaining power than mayors in Quito or Guayaquil.

Additionally, the adoption of a special Law for distributing (earmarking) 15% of the Central Government Budget for sectional governments in 1997 has strengthened their capacity to do public works in their districts. Together with other transfers, it is estimated that sectional governments benefit from at least 20% of the General Budget and that they retain around 50% of the public sectors' investment capacity[48] . Increased municipal resources have contributed to improving basic coverage of municipal services such as water, electricity, sewerage, but perhaps most importantly, they shielded municipal governments from the 1999 crisis.[49]

A third factor of chance is the reform of the legal framework to grant mayors more prerogatives and responsibilities over resource allocation in their districts. Some decentralization has already taken place with the adoption of a *Ley Orgánica de Régimen Municipal* and a *Ley Especial de*

[44] MEF, Subsecretaría de presupuestos, SIGEF, Catálogo institucional, ejercicio fiscal 2006.
[45] María Dolores Almeida, Gobernabilidad Fiscal en Ecuador, July 2005
[46] Before 1998, the chief of the municipal government was the *presidente municipal* and only a handful of mayors from the larger Ecuadorian cities were elected. After 1998, these politicians were elected as mayors for four year terms. We claim that this is not merely a name change, but rather -as outlined in this section- there were significant changes in power, resources and prerogatives available to the new elected officials.
[47] The AME has been formally constituted since 1942.
[48] MEF and Santiago Ortiz, FLACSO, personal communication with the authors.
[49] Santiago Ortiz, FLACSO, personal communication with the authors.

Descentralización y Participación Social (approved in 1997), although in practice much of the formal policymaking prerogatives remain centralized. The 2004 reform to the *Ley Orgánica de Régimen Municipal* intends to fill in this gap by strengthening municipal autonomy, but this reform is not likely to bring greater fiscal transparency since from a political perspective, mayors would have more incentives to prefer an increase on spending privileges rather than taxing abilities.

The increased role of local governments as stronger budget players is reflected by a radical but consistent shift of political dynamics, from the national legislature to the sub national arena after 1998. As it will be illustrated in the next section, legislators and political parties have gradually lost their ability to bargain for provincial and discretionary allocations (1995), and the exchange of political favors with the government has been penalized with expulsion from the legislature (Ethics Code, 1998). Thus, legislators and their parties have moved from a resource-dry and highly conflictive congressional arena to the sub-national arena, where they have been more successful in protecting their budgetary allocations, and where they enjoy more financial resources to maintain their hegemony, perform constituency services and maintain a healthy electoral connection.[50] During the 2000 mayoral elections, several party leaders abandoned their legislative seats to run for local governments, most prominently, this is the case of current mayors of Quito and Guayaquil, Paco Moncayo (ID) and Jaime Nebot (PSC) respectively. Politically, this seems to be a good strategy. Some city mayors have enough leverage to bargain allocations directly with the office of the president, to run some public services of their own, such as the civil registry, and to influence important aspects of national policy making. Arguably, it is also perceived by mayors and the public opinion that democracy and governability was upheld in their cities at times of national political and constitutional crises.

More empirical research is needed to understand the workings of a sub national budget making process. Table 4 illustrates a dramatic increase in the number of mayors elected in Ecuador after the 1998 constitutional reforms. The table shows a clear move of the most influential Ecuadorian parties to capture local government posts. After 1998, nearly two thirds of the total number of mayoral posts available (in the 2000 and 2004 elections) was captured by the four largest parties (75% if we also count Pachakutik). Furthermore, this partisan occupation of the sub national arena is consistent with regional trends of party competition. On average, 52% of the mayors coming from "coastal" parties, PRE and PSC, won elections in "coastal" districts (while 31% and 16% won in the Highlands and the Amazon and Galapagos respectively).[51] By the same token, on average 52% of the mayors coming from "sierra" parties, the ID, DP and Pachakutik, were elected in Highland districts (while only 22.4% and 25.7% in the Coast and Amazon/Galapagos regions).

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[50] Interview # 3.

[51] Coastal provinces are Esmeraldas, Manabi, Los Rios, Guayas and El Oro. Highland districts are Carchi, Imbabura, Pichincha, Cotopaxi, Tungurahua, Chimborazo, Bolivar, Cañar, Azuay and Loja. Amazon provinces are Napo, sucumbios, Orellana, Pastaza, Zamora Chichipe and Morona Santiago.

Table 4. Number of Mayors elected by political party, before and after 1998

Party	*Total Mayors*	*Before 1998*	*After 1998*
PSC	131	5 (12.5%)	126 (28.9%)
PRE	74	9 (22.5%)	65 (14.9%)
DP	55	5 (12.5%)	50 (11.5%)
ID	53	3 (7.5%)	50 (11.5%)
PCK	42	1 (2.5%)	41 (9.4%)
PSP	21	0 (0%)	21 (4.8%)
PRIAN	20	0 (0%)	20 (4.6%)
CFP	19	2 (5%)	17 (3.9%)
MPD	15	1 (2.5%)	14 (3.2%)
Others*	46	14 (35%)	32 (7.2%)
Grand Total**	476	40 (100%)	436 (100%)

* Other parties before 1998 include: APRE, PCD, PD, PNR, PSE, PCE, PLRE, and FRA. After 1998, Other parties include PSE, PCE, PLRE, FRA as well as regional and provincial movements like: MFIMA, MFIP, MIAJ, MICLD, MICMS, MIJ, MIL, MIPB, MPTSF, MUPI.
Source: Tribunal Supremo Electoral.
** Before 1998, only 40 city mayors were elected in Ecuador, while a *presidente municipal* was the elected official for smaller cities. After 1998, these politicians were elected as mayors for four year terms. As argued in this section, this was not a simple name change, but there were rather significant changes in power, resources and prerogatives available to these officials.

This section suggested that the increased participation of local governments, especially after the 1998 constitutional reforms, has contributed to the politicization of the budget process at the sub national level. The following section lends further evidence that political parties divided along regional lines, have moved away from the legislative arena thus contributing to the politicization of sub national governments and leaving a representation vacuum at the national level.

5.2 Legislative Approval

Legislative approval is the stage where congress could have the most significant impact on the budget process, given its limited ability or capacity to influence the design and execution stages -usually in the hands of the Finance Minister-, or perform budget monitoring -usually carried out by the General Comptroller. At this stage, congress receives the budget proposal from the executive on September 1. and has three months (until November 30) to discuss the appropriate revisions in the Budget committee and approve the budget in plenary session. Failure to consider the executive's budget will result in the automatic approval of the president's proposal. In practice, the legislative ability to make a significant impact on budget contents and reallocations has diminished over time. For example, congress can make amendments to the executive's proposal by spending sectors only, before the proposal is returned to the floor to be voted by the entire chamber.[52]

Consistent with the role congress has played in the broader policymaking process, it has been also perceived by the government and the public that the legislature significantly increases the transaction costs of budget approval. Among other things, this is due to the highly fragmented

[52] Political Constitution, Art. 258.

and regionalized nature of political parties in the unicameral congress. Congress is composed of 100 provincial legislators from 22 provinces who are elected by a formula that allows voters to express personal preferences for candidates but allocates seats using proportional representation.[53] Legislators are elected for a four year term with no term limits.[54] Additionally, the Ecuadorian congress is known for having one of the most regionalized party systems (Jones and Mainwaring 2003), and one of the worst malapportioned lower chambers in the region (Snyder and Samuels 2001).[55] The latter means that provinces with smaller populations are heavily over represented in detriment of the larger ones. In 2002 for instance, a legislator from the province of Guayas represented approximately 22 times as many voters as those represented by a legislator from Galapagos.[56]

The combined effect of post 1998 reforms should have, in theory, increased the legislators' incentives to cultivate an "electoral connection" with their constituents and therefore demand larger government spending for their provinces to advance their own political careers, without assuming the costs of fiscal discipline at the national level.[57] In practice, the legislators' incentives to cultivate a personal vote in their provinces were offset by an increase of the executive's agenda setting power in budgetary affairs and a decrease of the budget available to the executive for bargaining political support. The following section discusses the impact of 1998 constitutional reforms along three areas of the budget approval stage: the budget committee, the available currencies for political bargaining and the time horizons of legislators.

5.2.1 Changes in the agenda setting power of the Budget committee

The legislative committee in charge of revising the executive's budget proposal is the Comisión de lo Tributario, Fiscal y Bancario (CTFB or Budget committee hereafter). The 7-member budget committee has the prerogative to revise the president's proposed budget and to suggest amendments –which include regional, sectorial and partisan demands- for their vote on the floor or *Pleno*.[58] The congress does not have the power to create additional spending lines. Before the 1998 constitutional reforms, the amended budget was voted by simple majority in the *Plenario*

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[53] The electoral formula to allocate votes into seats in Ecuador has varied greatly over time. Between 1979 and 1996 it featured a closed list system that gave party leaders strong prerogatives over candidate nomination and selection. A personalized form of voting was adopted in 1997, by which voters could elect as many representatives as seats were available in the district, regardless of party lists or party affiliation. Some reforms have been introduced in 2000 and 2001 to gradually return to a party list system.

[54] Before 1996 legislators could not be immediately reelected, and before 1998 provincial legislators were elected for a two year period only.

[55] In a comparison of 76 countries, Snyder and Samuels (2001) find that Ecuador has the second highest malapportionment in lower chambers after Tanzania (24% and 27% respectively), and the highest in the Latin American region, followed by Bolivia (17%).

[56] The problem of malapportionment was more severe before the 1998 Constitutional reforms, as the number of legislators changed from 82 in 1996, to 123 in 1998, and back to 100 in 2002. The reduction in malapportionment is effective even after National legislators –who have an equalizing effect of territorial disparities- were abolished in 1998. The reduction in malapportionment is effective even after National legislators –who have an equalizing effect of territorial disparities- were abolished in 1998.

[57] According to a elite survey, over 60% of Ecuadorian legislators considered in 1998 that bringing resources to their provinces was very important (Mateos and Alcantara 1998).

[58] The Budget committee was made of 5 members and their alternates between 1979 and 1983.

de las Comisiones Legislativas, a sub chamber or council composed of all legislators who were members of the five Permanent Committees.[59] This system, valid between 1979 and 1998, nominally gave budget committee members the prerogative to revise the presidents' proposed budget, but retained real decision making power on the final amendments within the 35 member *Plenario*.

The adoption of a different committee system after 1998 *increased the agenda setting power* of the budget committee while it *disseminated decision making capability* to the entire congressional floor (*Pleno*). In the old system, party leaders bargained minimal winning budget coalitions outside the budget committee, directly negotiating the direction and the amount of budget allocations (*partidas de gasto*) between the executive and the *Plenario*. Though budget bargaining was not cheap, coalitions were cemented with some degree of political credibility: budget allocations were granted to legislators' constituencies and budgets were approved with a simple majority of partisan and independent *Plenario* members. These allocations, though conventionally associated with the distribution of pork (or "troncha") to clientelistic interest groups, they also contained investment projects that benefited provincial governments. Thus, the allocation of resources to partisan strongholds could have helped cement sustainable coalitions around budget allocations.

The practice of approving budgets in the *Plenario* generally benefited parties with larger contingents in congress. The approval of the 1997 budget challenged this system, as president Bucaram bypassed traditional parties and approved his own budget agenda with the support of 6 out of 7 CTFB members and 18 members of the *Plenario* (PRE and independent legislators).[60] The excluded parties, PSC, ID, DP, MPD, and Pachakutik opposed the presidents' maneuvering but failed to bring the budget debate to the entire congressional floor, where the opposition had a majority of seats.[61] The following year, these party leaders introduced the reforms which centralized agenda setting in the budget committee but opened the budget approval to the entire floor, under the discourse of increasing accountability in the legislative process. In practice, party leaders sought to strengthen the parties' control of the committee system as an insurance mechanism against the presidents' ability to form cheaper and quicker budget majorities with individual legislators. In following years, these parties also gained greater control of the budget committee. A closer look at the partisan and regional composition of the 137 members appointed to the budget committee between 1979 and 2003, shows that parties and legislators gained greater control of the budget approval process in congress. The data suggests that parties and their leaders invested more resources in the strengthening of the committee system after 1998. Between 1979 and 1996, partisan affiliation to the CTFB was evenly distributed across political parties, with ID having 17% of all budget committee members during this period, and DP, PSC, PRE, CFP and PCE having had between 10% and 12% of the total number of

[59] In addition to CTFB, the other four Permanent Committees were: Comisión de Mesa, de lo Civil y Penal, de lo Laboral y Social, y de lo Economico, Agrario, Industrial y Comercial.
[60] Diario Hoy, Quito, December 11, 1996. www.explored.com.ec
[61] Incidentally, this is the same coalition of parties that two months later contributed to the congressional destitution of president Bucaram, in February 1997.

committee assignments each.[62] After 1998, 93% of the total number of committee assignments was nearly monopolized by four political parties: DP, PRE, PSC and ID in that order.[63]

This takeover of CTFB assignments also reproduced the regional party competition (PRE against PSC in the coast, DP against ID in the highlands) that has developed in congress over the last decade. The territorial composition of the budget committee suggests that the 1998 reforms –which also eliminated National legislators-, introduced a heavier representation bias in favor of larger provinces. Before 1998, roughly 31% of CTFB members came from the three largest provinces, Pichincha, Guayas and Manabí, and another 12.3% came from the National district. After 1998, the percentage of CTFB members coming from the three largest provinces nearly doubled that of the previous period (57%). One province alone (Pichincha), where the country's capital is located, contributed with 42% of all members.

5.2.2 Changes in politicians' time horizons

A second set of changes that significantly affected the budget approval process was the expansion of legislative time horizons. Longer time horizons should in theory provide incentives to develop political careers and sustain long-term agreements. Legislative appointments (including the presidency of congress and legislative committees) were extended from one to two years, thus reinforcing existing incentives to expand legislators' horizons given by the elimination of term limits (1995) and mid term elections (1998). Before the approval of these reforms, there is no compelling evidence showing that individual legislators pursued political careers or sought to accumulate legislative expertise (Mejia Acosta 2003).[64] In the entire 1979-2003 period, only two legislators served in the CTFB more than five times, and three more served four times. In only two cases, Simon Bustamante (PSC) and Wilfrido Lucero (DP-ID), legislators also presided over the budget committee –Bustamante-, or served as president of congress –Lucero-. In the post-1998 era, five out of seven legislators appointed to the CTFB in 1998, served in the committee for another two years. Although this is little data to generalize, legislators indicate a preference for accumulating seniority and budget expertise in the post-1998 period.

5.2.3 Changes in coalition currencies

A third institutional change that affected the costs of budget approval was the requirement that legislators approve the budget by sectorial spending rather than by budgetary allocations, and the removal of legislators' ability to execute budget funds for their provinces.[65] The proposed

[62] The pattern is consistent with low levels of political expertise in committees during this period (Mejia Acosta 2003).
[63] The total number of members is 14, 7 elected for a two year period in 1998 and 2000.
[64] Even for national legislators who were elected for a four year period, it was more interesting and politically savvy to "hop" to more visible committees such as Political Oversight (Fiscalización), rather than going to technical or policy committees.
[65] The *Consulta Popular* was held on August 28, 1994, and its exact questions were: *¿Deberían los Legisladores manejar Fondos del Presupuesto del Estado?*, and *¿Deberían los Legisladores aprobar el Presupuesto del Estado por Sectores de Gasto, o por Partidas Presupuestarias?*

reforms were submitted by president Durán Ballén and approved by popular referenda (consulta popular) in 1994, as an attempt to reduce and eliminate legislators' rent seeking incentives during the process of budget approval. Before the reforms, legislators had access to provincial funds that were equally distributed from the budget.[66]

Why would the executive voluntarily abdicate its ability and discretion to distribute funds and bargain budget coalitions with legislators? It was perceived within the Durán Ballén administration that budget approval and other political bargains were becoming too expensive to sustain, especially with certain political parties. In a telephone interview, former Vice-president Dahik recognized that:

> "(a group of PSC legislators) would ask for provincial funds in return for supporting some of our laws (…) And their family members would be the contractors. It was an absurd situation because their leaders were in opposition, but meanwhile some of the deputies were constantly sitting down with us, demanding money. It was collective bargaining, and the whole process was very expensive" (Landau 2001: 47).[67]

By limiting the ability of the congress to reallocate provincial funds, the government had hoped to decrease the particularistic demands for government spending, and allow for a smoother, more technical process of budget approval. The strategy to dry the available resources to "grease" political coalitions backfired, as party leaders refused to approve the proposed budget by sectorial spending and, according to the media, such parties insisted on obtaining budgetary allocations for their provinces and local governments.[68] One year later, frustrated party leaders – who had earlier benefited from discretionary payments from the government themselves- accused Vice president Dahik of vote buying and mismanagement of discretionary funds (gastos reservados). The corruption scandal drove Vice president Dahik out of office in 1995, but the congressional hearing during the impeachment trial revealed a complex network of legal and illegal transactions that were commonly used by the government to buy legislative support from political parties (Mejía Acosta 2006).

In the aftermath of the Dahik scandal, and other corruption incidents during the Bucaram and Alarcon administrations, the newly elected 1998 congress sponsored and approved an Ethics Code, which further restricted legislators' ability to negotiate material and political resources for their districts or themselves. Although in theory the Code threatened defecting legislators with expulsion, it has not been applied to date, nor has it altered the incidence of party switching for political gain. The effects of the eradication of coalition incentives on the budget approval process are best summarized by a congressional party leader:[69]

> "In the past, corruption was very functional for governance. The Presidency, the administration's Secretary General, the Minster of Defense and the Minister of the Interior all had discretionary expenditures. Even if many don't like to accept it, these served in the past to buy legislators, to buy loyalties in detriment of (the

[66] According to Landau, in 1993 legislators were entitled to an equal share of $500 million sucres from *partidas presupuestarias*, but in practice some legislators obtained the lions' share of budget allocations while many others did not (See Landau 2001: 44).

[67] Alberto Dahik, Telephone interview by David Landau on Jan 30, 2001.

[68] According to Diario Hoy, PRE and PSC would have only approved the proposed budget if the government granted them 600 thousand millon sucres for their provinces. Diario Hoy, Quito, December 30, 1994. www.explored.com

[69] Interview # 6. July 22, 1999.

> discipline of) the political parties. A Budget Committee existed where, if conflicts arose, they were taken to the Plenary. It was a functional system: 18 years of democracy and there were no problems associated with the approval of the fiscal budget. The amount of the budget was negotiated by sectors, and legislators negotiated the amounts by entries, by allocations. It was an open secret. Legislators in the Budget Committee (…) negotiated giant allocations for themselves: they (arbitrarily) selected contractors, and it did not encounter problems with the Comptroller's Office because they (political parties) controlled the provincial comptrollers, the judicial branch, etc. These mechanisms no longer exist. While there is more transparency (in the budget process), sectors feel powerless to obtain gains and vent their frustration by radically opposing government initiatives".

The attempt to create a smoother and more transparent budget process at the approval stage by eradicating existing material incentives for coalition formation produced the opposite effect. The lack of available and legal currencies dramatically increased the executive's costs of approving budgets in congress and made coalition formation a more unstable and unreliable process. Assessing the changing costs of making budget coalitions remains an empirical question which can not be properly tested in the Ecuadorian context, given that there is no roll call voting data available, nor there is government expenditure data disaggregated by province.

An evaluation of the overall impact of political reforms on budget approval poses interesting questions that deserve further research and empirical testing. On the one hand, the strengthening of the budget committee and its increased control by parties and legislators after the 1998 reforms is a paradoxical finding in the broader context where the Executive retains significant budget powers especially during formulation and execution. Furthermore, these parties and legislators seem to be interested in seeking continued presence and gain expertise in the Budget Committee. On the other hand, legislators in the post 1998 period have lost access to key budgetary resources or formal currencies that would have encouraged and cemented more durable agreements around budget outcomes. In short, a pending question is: Why would legislators have incentives to pursue continued political membership in a committee that has diminishing access to effective resource allocation?

One hypothesis is that parties and legislators in the national congress have become imperfect agents of provincial representation, indirectly or marginally negotiating investment projects for the interest of their provincial constituencies, which are later executed by regional, provincial or municipal governments. The case of Simon Bustamante, a PSC legislator from the province of Manabi is a good example to illustrate this possible link. Bustamante has presided over the CTFB in three of the four times in which he has been a member, and it is believed that he has played a critical role in helping channel budget allocations and regional development programs to his native province. Furthermore, his political party has gained an important presence in the provincial and municipal government over the last years.

The other hypothesis, as already suggested in the earlier discussion of sub national governments (5.1.4) is that parties and legislators moved from the resource-dry legislative arena to the resource-abundant sub national arena, where they have more prerogatives to bargain for budgetary allocations. Additionally, the possibility of reelection means that politicians have clearer opportunities to develop long term relations of accountability with their constituents. This could be the case of some legislators and influential leaders of their congressional parties who in 2000 abandoned the national arena to run successfully for local office: Paco Moncayo

(ID) who became mayor of Quito –twice-, Jaime Nebot (PSC) who became mayor of Guayaquil –twice-, and Jorge Marun (PRE) who became Prefect of the Los Rios Province.

In any case, the two hypotheses suggest a significant shift of budget dynamics after 1998, from the national to the sub national arena. Further exploring these hypotheses would contribute to a better understanding of the political linkages between national and sub national governments in the budget process.

5.3 Budgetary Execution

Formally speaking, the UEs' are primarily responsible for budgetary execution. In practice, the Sub-secretary's office of Budgets and the Treasury establish allocation priorities to avoid coordination problems in the allocation of the cash flow. According to the Law, the elaboration and execution of fiscal policies is the Executive's responsibility, therefore the MEF, in accordance with the requirements and taking into account the budget's lack of flexibility, establishes a priority order to assign resources according to its governance needs.[70] At the moment, the priority order is as follows: i) debt interest payments, ii) wages, iii) transfers[71] and iv) capital expenditure. Furthermore, the MEF can reassign and adjust the approved budget through modifications during the fiscal year without congress having to approve each modification.[72] For example, the MEF can cut up to a 5% in government expenditures once the final budget is approved. Additionally, the Minister has discretional powers to reallocate funds within the approved budget through the interpretation of *budgetary classifiers*, although this is not officially established.

Table 5 describes the actual allocation of resources across spending items at each stage of the budget process. About half of the spending in the budget proposal presented by the Executive is absorbed by four sectors –some of them with the largest role of civil servants: Education, Defense, Health, and Social Welfare and Labor. In relative terms, allocation across sectors remains relatively stable during the process, with some clear outliers. Notwithstanding, there are differences on the relative ability of the different sectors to "protect" their share of total spending through the process, which will be explored in more detail later. The sector with the most dramatic decrease in its share on total spending through the budget process is Social Welfare and Labor, which at the proposal stage receives 6.7% of total spending, but at execution stage, represents only 3% of total spending.

On the other extreme, (and consistent with the large degree of discretion of the Ministry of Economics throughout the budget process), the sector with the most dramatic increase in its share on total spending throughout the process is Finance, with only 2% of spending at proposal stage and 6% of total spending at execution. Note that there are also differences in the level of publicity across sectors: while transfers to sectors such as Social Welfare and Labor can be more advertised and controversial, nobody monitors or keeps track of the amount resources that go to Finance

[70] Political Constitution, Art. 260. MEF, according to estimates, approximately 85% of the budget is assigned to current expenditures and debt payments.
[71] Includes transfers to sectional governments and compensations such as the Human Development Bond.
[72] Budget Law, Art. 54. According to estimates, approximately 2000 modifications were made to the GGB.

Table 5. Percentage composition of spending at different stages of the budget process

	B	L	R	D		B	L	R	D
Administration	1.6	1.4	1.4	2.8	Finance	2.0	2.5	2.6	6.0
	1.0	0.7	0.8	2.1		1.4	1.8	1.6	6.0
Agriculture	6.7	6.7	6.8	5.7	Industries and Trade	0.4	0.4	0.4	1.1
	2.9	2.9	2.8	2.6		0.3	0.3	0.3	1.8
Internal affairs	7.9	8.4	7.9	8.9	Judiciary	1.7	1.9	1.8	1.9
	2.3	2.1	1.5	1.9		0.9	0.8	0.6	0.6
External affairs	2.0	1.9	1.8	1.7	Legislative	0.7	0.9	0.8	0.8
	0.7	0.5	0.5	0.5		0.3	0.4	0.3	0.2
Social welfare and labor	6.7	6.4	6.1	3.1	Environment	0.6	0.4	0.4	0.3
	3.3	3.0	3.0	1.1		0.4	0.1	0.1	0.2
Public works	10.6	9.4	9.4	7.5	Other agencies	0.8	0.5	0.9	0.8
	6.4	3.2	3.0	1.8		1.2	0.3	1.3	0.3
Defense	14.8	15.0	14.7	16.4	Natural resources	0.8	0.6	0.6	1.2
	3.2	1.6	1.7	1.8		0.7	0.4	0.4	1.6
Urban development and housing	2.7	2.5	2.5	2.2	Health	8.6	8.2	7.9	7.4
	1.6	1.1	1.2	1.6		2.5	1.9	1.9	1.5
Education	21.1	21.9	21.6	21.5	Tourism	0.2	0.2	0.1	0.1
	5.7	4.2	4.3	4.0		0.2	0.1	0.1	0.1
Sub national governments	12.6	13.1	13.3	12.3					
	6.7	6.2	5.9	8.0					

Note: B=composition of spending in Executive budget proposal, L=composition of spending in budget law approved by congress, R=real composition of spending in budget law approved by congress, D=composition of spending in the total executed expenditure. Within each item, n=17 for column B (1990-2006), n=16 for column L (1990-2005), and n=15 for columns R and D (1990-2004). For comparability, debt payments have been excluded from the budget.
Source: Data collected by the authors for this paper from congress and the Ministry of Economics and Finance.

Table 6 and Table 7 summarize the direction of reallocations during the budget process across sectors. Table 6 presents the *sign* (positive or negative) of the mean change in reallocation over the period of study measured as: *share of item i at stage Y - share of item i at stage X*, where stage *Y* is always subsequent (in chronological terms) to *X*. This means that a positive sign can be interpreted as a reallocation that increased resources (in relative terms) for any given item, while a negative sign is a decrease in the share spending that goes to that item. Table 6 summarizes the signs for all four pairs of stages in the budget process that are being examined (two related to approval and two to execution).

Table 6. Direction of the changes in the composition of expenditure at different stages of the process

	L-B	R-B	D-R	D-B
Administration	-	-	+	+
Agriculture	-	-	-	-
Internal affairs	+	+	+	+
External affairs	-	-	-	-
Social welfare and Labor	-	-	-	-
Public works	+	+	-	-
Defense	-	-	+	+
Urban development and housing	+	+	-	-
Education	+	-	-	-
Finance	+	+	+	+
Sub national governments	+	+	-	+
Industries and Trade	-	-	+	+
Judiciary	+	+	+	+
Legislative	+	+	-	+
Environment	+	-	-	-
Other agencies	-	-	-	-
Natural resources	+	+	+	+
Health	-	-	-	-
Tourism	+	+	-	-

Note: B=composition of spending in Executive budget proposal, L=composition of spending in budget law approved by congress, R=real composition of spending in budget law approved by congress, D=composition of spending in the total executed expenditure. Within each item, n=17 for column B (1990-2006), n=16 for column L (1990-2005), and n=15 for columns R and D (1990-2004). For comparability, debt payments have been excluded from the budget.
Source: Data collected by the authors for this paper from congress and the Ministry of Economics and Finance.

The purpose of Table 7 is to construct an item typology. It is based on columns 2 and 3 from Table 6 – or the comparison of the budget presented to congress to the budget that was really approved and the comparison of the latter to what was finally executed. Sectors with very small participations in spending (less than 1.5% of total) are in italics. The table proposes four types of spending items:

- *Successful lobbyists and over spenders*: These are the items that succeed at attracting a larger share of spending both at approval and at execution stage. The items that fall under this category are strong –from a technical or a political standpoint- in the government: Internal Affairs, the Judiciary, and the Ministry of Finance. Interestingly, Finance appears to be more condescending with regards to its own spending than it is to others' at execution stage.
- *Successful lobbyists and under-executers*: These are items that –at approval stage- receive a larger share of budget resources but that –later, during execution- end up spending less than their allocated share. It is likely that Public Works and Housing are sectors where expenses could be over-budgeted because the Executive knows it is relatively easy to make any adjustments out of capital investments at execution stage. The presence of Sub

- National Governments in this category reinforces the notion that these actors can have different ways to influence budget dynamics and outcomes at approval and execution stages. A particular case is that of provincial strikes, often sponsored by the provincial authority, that get resolved when the central government commits to finance some local public investment. Frequently these resources are reallocated and accounted from the budget of the Ministry of Public Works, but transferred directly to the provincial government that executes the construction. These reallocations often occur under tight time pressure and therefore were never planned in the approved budget. They ultimately translate themselves into reallocations (within and across sectoral items) at execution stage. It is likely that they imply important tradeoffs in terms of other projects and priorities.
- *Unsuccessful lobbyists and over spenders:* These are items that receive negative net reallocations at approval stage but ultimately end up spending a larger share of the budget that the one which was initially assigned to them. The Administration and Defense fall under this category. These sectors seem to reserve their political capital to increase their share in the budget during execution, while keeping a low profile at approval stage.
- *Unsuccessful lobbyists and under spenders:* The spending in these items is negatively affected at both approval and execution stages. These are items with disorganized, disperse, or effectively weak political constituencies (External affairs, Social Welfare and Labor, Agriculture, Education, and Health). It is not surprising that they are the net losers in relative terms at both stages. All of the social spending is clustered in this cell. Despite the fact that two sectors in this cell absorb a large share of the salary spending (teachers and doctors), and although these are powerful and organized groups, the "constituencies" that they represent do not succeed at approval stage or even execution stages. At the same time – and given the large relative importance of Education and Health over total spending- they are also candidates to experience relative cuts at execution. Moreover, it is likely that due to the large bureaucratic structures under these sectors, they are relatively less flexible to adjust their budgets at execution stage, even when adjustments would mean increasing their relative share on total spending.

Table 7. Types of budget lobbyists and executers (summary of table 9)

		Approval (Really approved – Presented)	
		+	-
Execution (Executed – Really approved)	+	**Successful lobbyists and Over spenders** Finance Internal affairs Judiciary *Natural resources*	**Unsuccessful lobbyists but Over-spenders** Administration Defense *Industries and trade*
	-	**Successful lobbyists but Under-executers** Public works Urban development & housing Sub national governments *Legislative* *Tourism*	**Unsuccessful lobbyists and Under-executers** Agriculture External affairs Social Welfare and Labor Education Health *Environment* *Other agencies*

Note: The sectors whose share in spending was less than 1.5% of total are in italics.

It is worth noting that the typology is of purely descriptive nature and says little as to the causes of different outcomes. Specially the issue of over and under spending could be related to multiple causes ranging from the limited technical capacity of the agency in charge of operationalizing that item of spending to the discretion of the Ministry of Finance at execution stage. An example of the former is the case of some programs with very small technical and operational capacity inside the Ministries of Social Welfare and Labor where the agency does not manage to use their resources during the fiscal year (which have been identified in the World Bank - Inter American Development Bank Public Expenditure Review). An example of the latter is the case of Public Works, which is usually an item that faces cuts and adjustments during execution since it has a large component of investment (versus recurrent spending, like salaries, which cannot be avoided).

5.4 Enforcement

The State's Constitution[73] establishes the actors related to this stage: i) Executing Units, ii) General Comptroller's Office and iii) National congress. The system of control, censuring and auditing of the State[74] has two components: i) internal control and ii) external control. The UEs have to ensure the creation and maintenance of their internal control system, through which public servants and functionaries report on and make themselves responsible for the execution of their attributions, the use of public resources and the results obtained.[75] The internal control exercise has to be applied before, during and after through the specialized units in each of the UEs, which have to comply with the regulations in force established by Law. [76] External control is exercised by the General Comptroller's Office, which is an independent institution, and National congress, being the active participant the General Comptroller's Office. Even though there is a constitutional mandate for National congress to follow-up on the budgetary execution, in practice it has no technical capacity to do it. The participation of the General Comptroller's Office is ex-post the budgetary execution; therefore, timely alerts on the execution quality of expenditure of the UEs have to come from the internal control. It is worth mentioning that the large number of UEs makes it impossible for the General Comptroller's Office to exercise external control on all of them systematically.[77]

The approval of the Access to Public Information and Transparency Law (LOTAIP) in 2004 established a legal framework to facilitate the participation of citizens in the supervision of governmental actions and decision-making.[78]The LOTAIP mandates that government entities publish at least the following information: i) legal base and organizational structure, ii)institution's board, iii) wages; budgetary information; travel allowances; collective agreements; iv) auditing results and information on pre-contractual processes; v) list of people and businesses that have failed to fulfill contracts with the institution; vi) plans and programs that are being executed by the institution, vii) detailed information on domestic or foreign credit

[73] Political Constitution, Art. 211.
[74] General Comptroller's Office Law, Art. 6.
[75] General Comptroller's Office Law, Art. 5.
[76] General Comptroller's Office Law, Art. 12.
[77] According to estimates, 80% of the GGB is distributed in 100 institutions, with the General Comptroller's Office contributing with 1,700 employees.
[78] LOTAIP, May 2004, Art. 4 and 8.

contracts; viii) forms of accountability to citizens; among others. Furthermore, the Law also establishes specific sanctions to illegitimate acts of omission or denial of access to public information by state functionaries. [79] Even though the reform is recent, a number of citizen observatories have been organized to supervise the allocation and execution of fiscal expenditures. Some of the most relevant organizations that have an influence on the fiscal exercise are the Observatory of Fiscal Policy, the Observatory of Human Resources of the Health Sector, the Social Contract for Education, the Observatory of Children and Youth, the Observatory of Public Services, and the Observatory of Public Policies in the South, among others. In the long run, these watchdogs can play a complementary role to that of the governmental institutions to improve the quality of budgetary execution and distribution.

6 The political determinants of Budget Outcomes

This section presents empirical evidence to assess the impact of institutional reforms on the sustainability, representativity, efficiency, and flexibility of budget outcomes. The level of detail and the type of analysis chosen for each of the budget outcomes were contingent on the availability of disaggregated data (regional or by budget item) for periods before and after the institutional changes.

The first part of this section presents a brief discussion of the sustainability of budget outcomes that illustrates how the Ecuadorian trends in revenues and spending compare of those of other Andean countries. Based on a review of secondary sources, this section documents that dollarization had a positive effect in improving the sustainability of budget outcomes. Secondly, the section offers a detailed analysis of the representativeness of budget outcomes. The effect of the 1998 Constitution is assessed by comparing the evolution of provincial budget allocations and a series of political variables reflective of the rules that were modified with this reform. The role of the Fiscal Responsibility Law is discussed through qualitative evidence that documents how incentives and timing affected the types of tradeoffs that congress was willing to make at budget approval. The next subsection explores the efficiency of budget outcomes by combining two types of data: first, it analyzes the magnitude of reallocations across budget items throughout the different stages of the budget process, and secondly it looks in detail into a case study in the education sector. The final subsection analyses the adaptability and rigidity of the budget and concludes that it the rigidity has grown in the last years.

6.1 Sustainability of budget outcomes

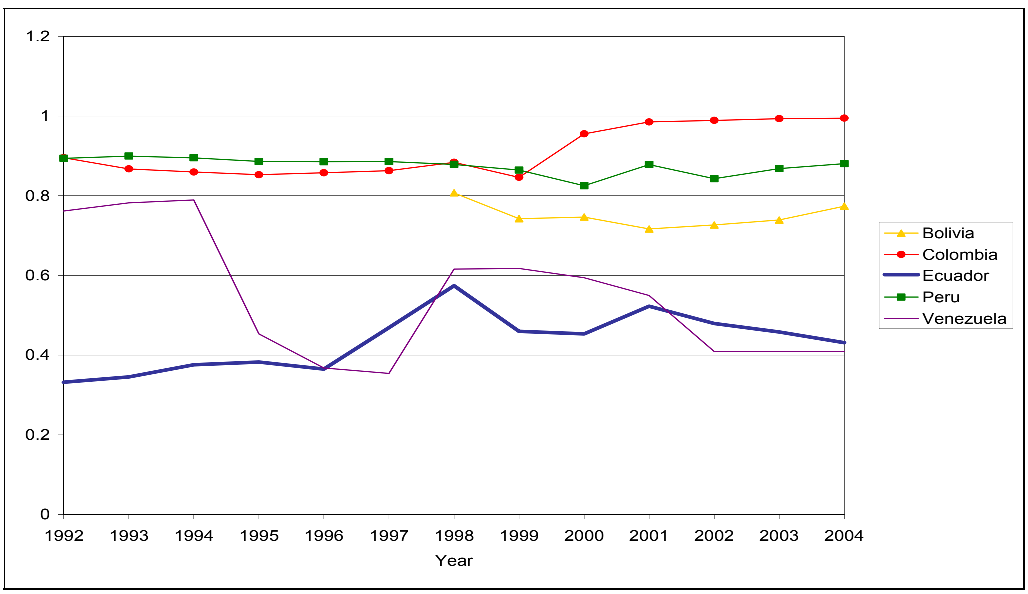
This section discusses whether the trends in fiscal results that have characterized the period of study can be sustained over time. This question is particularly important given that Ecuador -whose budget relies heavily on oil revenues- has experienced a period of stability (2002-2003) followed by a dramatic increase in the international price of oil (2003 onwards). While it is no possible to disentangle the direct and indirect effects of the1998 Constitution, the dollarization of the economy, and the rise in oil prices on fiscal sustainability, we argue that the Ecuadorian

[79] LOTAIP, May 2004, Art. 4 and 8.

economy remains vulnerable to external shocks in oil prices and that this constitutes the Achilles tendon of the sustainability of budget outcomes.
The material is organized in two parts. We begin with an overview of the recent evolution of Ecuador's main fiscal variables in relationship to those of the other Andean countries to document some of the trends in fiscal sustainability during the period of study. The second part provides an assessment of the sustainability of recent budget outcomes by reviewing some recent empirical studies on the Ecuadorian economy.

The evolution of three key fiscal variables -revenues, debt, and wages- in recent years is discussed first. On the revenues side, Figure 45 and Figure 56 depict the evolution of tax revenues and debt in the five Andean nations. Together with Venezuela, another economy heavily dependent on oil, Figure 4 illustrates that Ecuador has the lowest tax revenues as a share of total current revenues. The magnitude of the differences across countries is large: while tax revenues represented around 40% of current revenues in Ecuador and Venezuela in 2004, they were at least twice as large in Colombia, Bolivia and Peru. Consequently, tax revenues are substantially less erratic for the countries that are not heavily dependent on oil than they are for Ecuador and Venezuela, reflecting their vulnerability to changes in the international prices of oil.

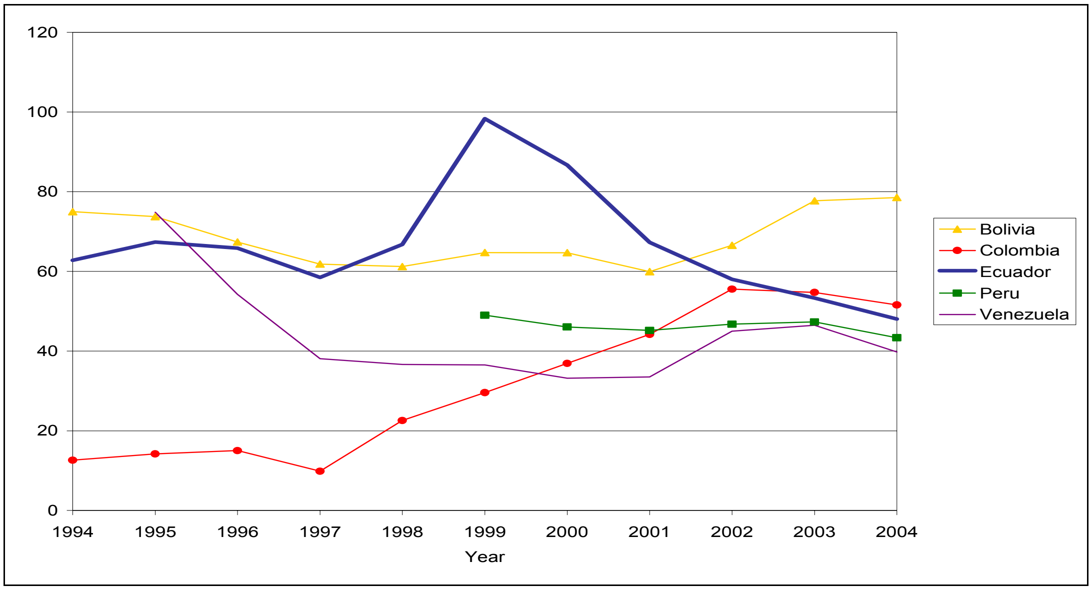
Figure 4: Tax revenues as a share of current revenues



Source: World Development Indicators, 2006.

Figure 5 depicts the evolution of the debt of the central government as a share of GDP. The trend of this variable in Ecuador differs substantially to that of its neighbors and is clearly related to the causes of the 1999 financial crisis and the subsequent recovery of the economy. The share of central government debt over GDP decreases substantially after 1999 and Ecuador remains at levels close to those of Colombia and Peru. The growth of GDP is a contributing factor to this downward trend of government debt.

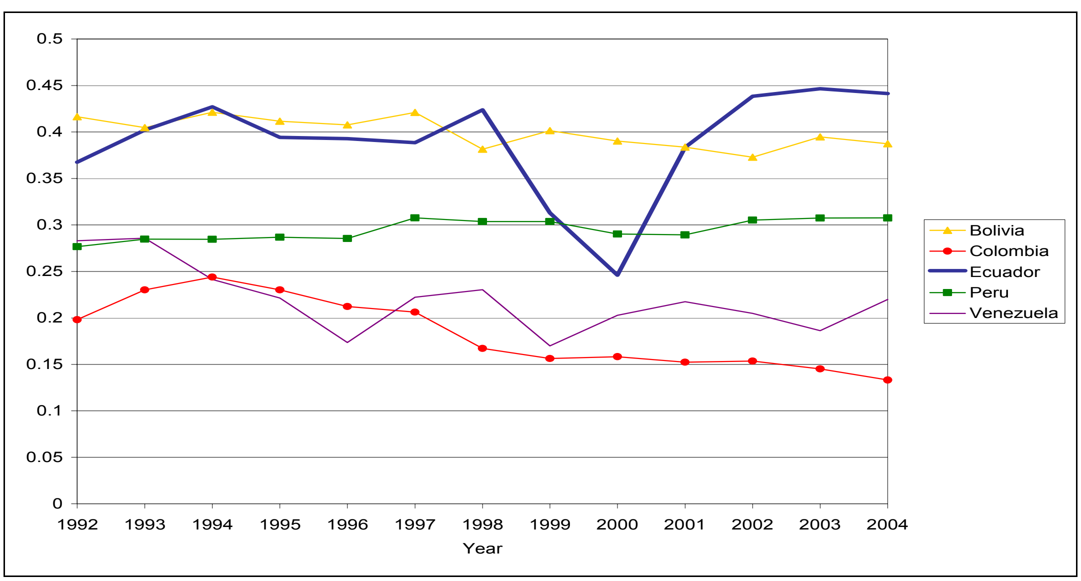
Figure 5: Total central government debt as a percentage of GDP



Source: World Development Indicators, 2006.

On the expenditures side, Figure 6 describes the evolution of public wages as a share of total primary spending between 1992 and 2004. The relative importance of wages on spending is substantially larger in Ecuador than it is in all other Andean nations except Bolivia. This factor was raised as a concern by the 2004 World Bank-Inter-American Development Bank Public Expenditure Review and explains part of the rigidity of Ecuador's public spending that will be analyzed in a later section. The figure also illustrates a sharp drop in this item during the years of the financial crisis, followed by a clear recovery to levels even above the ones pre-crisis.

Figure 6: Wages as a share of primary expenditure



Source: World Development Indicators, 2006.

Table 8 presents Ecuador's indicators from Figure 4, Figure 5, and Figure 6 as well as their averages during the pre and post dollarization and constitutional reform periods. The table shows that tax revenues have been systematically higher since the late 90s. This is related to important reforms in the internal revenue service. The table also illustrates that after 2000, there was a reduction in the share of central government debt on GDP and an increase in the share of wages on primary expenditure. These two patterns coincide with a period of stable and increasing international oil prices.

Table 7. Indicators of fiscal sustainability

	Tax revenues on current revenues	Central government debt on GDP	Wages on primary expenditure
1992	33%	89%	37%
1993	35%	73%	40%
1994	38%	63%	43%
1995	38%	67%	39%
1996	36%	66%	39%
1997	47%	58%	39%
1998	57%	67%	42%
1999	46%	98%	31%
2000	45%	87%	25%
2001	52%	67%	38%
2002	48%	58%	44%
2003	46%	53%	45%
2004	43%	48%	44%
Pre-post Constitution			
1992-1998 average	41%	69%	40%
1999-2004 average	47%	69%	38%
Pre-post dollarization			
1992-2000 average	42%	74%	37%
2001-2004 average	47%	57%	43%

Recent empirical studies of the fiscal sustainability of the Ecuadorian economy confirm that oil plays an important role in explaining recent trends. Díaz Alvarado, Izquierdo and Panizza (2004) found that although Ecuador's fiscal indicators have experienced an improvement in recent years, there are elements that could trigger a fiscal crisis, such as the large volatility of revenues. Specifically, they document that the country is vulnerable to external shocks to its current account such as a change in oil prices. They also point at the rigidity of government spending as a second factor that could generate a fiscal crisis. This is of particular concern since under a dollarized regime (where fiscal policy is the only instrument to shield against shocks), it would be even more desirable to have flexibility in this tool.

Another study on fiscal vulnerability in Ecuador (Barnhill and Kopits, 2003) assesses public debt outstanding and quantifies the effect of dollarization on fiscal sustainability. These authors present simulations of the distribution of the Ecuadorian government portfolio to determine the value at risk at given confidence intervals. The method they propose defines the value at risk as "the worst possible loss over a targeted horizon with a given level of confidence". The underlying assumption is that government adheres to all of the legal earmarking of its budget which –as has been documented here - is not always the case. Notwithstanding, their main finding is that dollarization substantially reduced fiscal vulnerability (the order of magnitude is between 14-16% of the net worth of Ecuador's public sector). They identify that the components of the government's balance sheet whose volatility has the largest contributions to fiscal vulnerability are: oil income, profits from state-owned enterprises, outstanding external liabilities, and liabilities of the pensions system.

In summary, while the evidence does suggest that budget outcomes show signs of more sustainability in recent years, it strongly points to the role that high and stable oil prices have played and continue to play on these outcomes. It is unclear and unlikely that budget outcomes could be sustained under different conditions in the international oil market. Moreover, and as will be analyzed in more detail in the section on rigidity of budget outcomes, high oil prices can have direct effects not only on budget outcomes but they can also affect budget outcomes indirectly, through the behaviors and preferences of the actors of the budget process. Specifically, if a period of prosperity translates into permanent earmarking and rigidity of resources, this could augment the negative effect of a fall in oil prices on the sustainability of budget outcomes.

6.2 Efficiency of Budget Outcomes

The role of institutional changes on efficiency of budget outcomes is explored through two alternative paths. The first part of this section explores the evolution of budget reallocations throughout the different stages of the budget process. The second part of this section looks at a very concrete case study -spending in primary schooling- to assess the efficiency tradeoffs and overall expenditure patterns observed throughout the period of study.

1.3.1. Efficiency in reallocations

In this section, we assess the 1990-2006 trends in the magnitude and direction of budget reallocations at different stages of the budget process. The focus is on changes in the magnitude of budget reallocations that emerged before and after two institutional changes: the 1998 Constitutional reform and dollarization. The role of the Fiscal Responsibility Law is also analyzed. Following Scartascini and Stein (see Annex 1), we compute a measure of the total change in the composition of spending for each pair of stages in the budget process.

This analysis focuses on a subset of the "*XY* intervals" in the budget process. Specifically, we compute the total changes in the composition of spending for the following intervals:

CBL= Total change in the composition of spending between the Executive's proposal and the budget law approved by congress.

CBR = Total change in the composition of spending between the Executive's proposal and the budget law really approved by congress.

CRD = Total change in the composition of spending between the budget law really approved by congress and execution.

CBD = Total change in the composition of spending between the Executive's proposal and execution.

Both *CBL* and *CBR* are approval intervals where the main actor responsible for budget reallocations is the congress in both the Budget Committee and the plenary. The congress decides on these reallocations based on the rules established in the laws (and the "acceptable" loopholes around them). Political pressure for reallocations - through different interest groups such as teacher unions or the sub national governments- can and does affect congress's behavior. On the other hand, *CRD* and *CBD* are execution intervals, where it is the Executive that has the largest discretion. At these stages, organized groups –and especially those with capacity to mobilize and/or paralyze the country- are the most likely to succeed in obtaining budget reallocations in their favor. The data allow us to compute CXY_{it} for years t=1990 … 2005 (and thus the addition of time subscripts) across 19 budget items[80]. 2005 data were only available for stages L and B.

Table 8, Table 9 and Figure 7 present some summary statistics on spending reallocations, using the formulas described before. Table 9 and Figure 7 depict the magnitude of the total spending reallocations at each stage and for each year, while Table 10 presents summary statistics of the item-level means. While the overall trends are consistent (one is just a weighted sum of the other), Table 8 allows to explore the dispersion of the item-level changes and to test whether there are any systematic differences over time.

Table 8. Total budget reallocations at different stages of the process

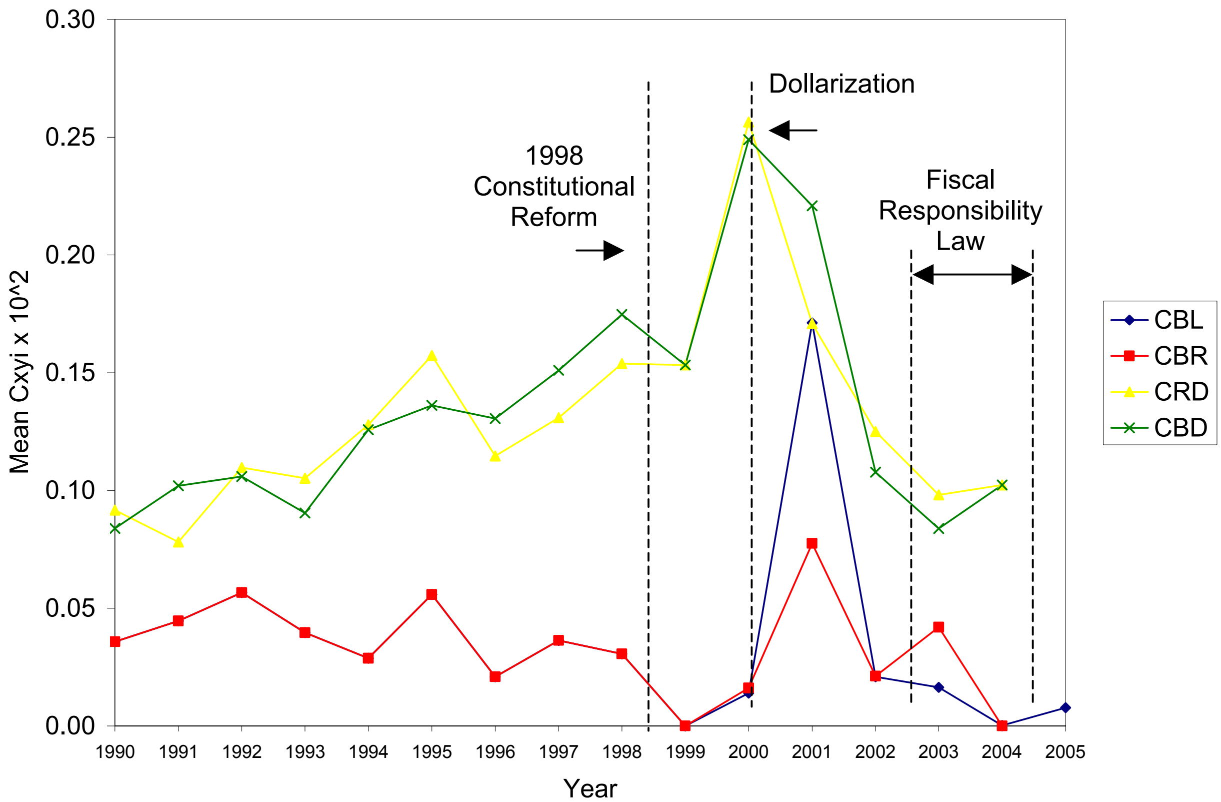
Year	C_{BL}	C_{BR}	C_{RD}	C_{BD}
1990	.0358	-	.0917	.0839
1991	.0446	-	.0780	.1020
1992	.0566	-	.1098	.1059
1993	.0396	-	.1051	.0905
1994	.0287	-	.1279	.1258
1995	.0558	-	.1573	.1362
1996	.0209	-	.1146	.1305
1997	.0363	-	.1309	.1511
1998	.0306	-	.1538	.1748
1999	.0000	.0000	.1532	.1532
2000	.0140	.0161	.2565	.2490
2001	.1712	.0775	.1709	.2209
2002	.0209	.0212	.1250	.1077

[80] Legislative, Judiciary, Administrative, Environment, Domestic Affaires, Defense, External Affairs, Finance, Education, Social Welfare and Labor, Health, Agriculture, Natural Resources, Industries and Commerce, Tourism, Public Works, Urban Development and Housing, Sub National Governments, and Other State Agencies. For comparability, Debt Payments were excluded from the budget.

2003	.0164	.0420	.0981	.0838
2004	.0002	.0000	.1023	.1023
2005	.0078	-	-	-
Average 1990-1998	0.039		0.119	0.122
Average 1999-2005	0.033	0.026	0.151	0.153
Average 1990-2000	0.033		0.134	0.137
Average 2001-2005	0.043	0.035	0.124	0.129

Note: B=composition of spending in Executive budget proposal, L=composition of spending in budget law approved by congress, R=real composition of spending in budget law approved by congress, D=composition of spending in the total executed expenditure. Within each year, n=19 expenditure items. For comparability, debt payments have been excluded from the budget.
Source: Data collected by the authors for this paper from congress and the Ministry of Economics and Finance.

Figure 7: Total budget reallocations at different stages of the process



Note: B=composition of spending in Executive budget proposal, L=composition of spending in budget law approved by congress, R=real composition of spending in budget law approved by congress, D=composition of spending in the total executed expenditure. Within each year, n=19 expenditure items. For comparability, debt payments have been excluded from the budget.
Source: Data collected by the authors for this paper from congress and the Ministry of Economics and Finance.

Two features are salient from Table 8 and Figure 7. First, they illustrate that for every year, the total magnitude of the changes during execution is much larger than that of those which occur during approval. In other words, the Executive plays a more important role than congress on budget outcomes. Second, it is clear that after the 1998 Constitutional reform, the real reallocations in the budget approved by congress are smaller than the ones that appear masked in the budget law. Although with the new Constitution, the average size of real reallocations at approval stage is smaller than before the Constitution, the difference is tiny. Second, the shape of the lines reveals that the overall magnitude of the reallocations in spending at all stages of the process has been decreasing clearly after dollarization for execution. Although, the interval is short, the magnitude of reallocations also seems to decrease for approval, especially in the interval when the FRL was in place. In other words, the FRL seems to have been effective in restraining budget reallocations at approval stage. In summary, all of the actors of the budget process seem to have experienced a reduction in their capacity to reallocate resources across items.

Table 9. Mean item-budget reallocations at different stages of the process

Year	Mean $C_{BLi}\times10^2$		Mean $C_{Bri}\times10^2$		Mean $C_{Rdi}\times10^2$	Mean $C_{Bdi}\times10^2$	
1990	.24		-		.61	.56	
1991	.30		-		.52	.68	
1992	.38		-		.73	.71	
1993	.25		-		.70	.60	
1994	.16		-		.71	.70	
1995	.31	*	-		.87	.76	
1996	.12		-		.64	.72	
1997	.20		-		.73	.84	
1998	.17	**	-		.85	.97	
1999	.00	**	.00	***	.81	.81	
2000	.07	***	.08		1.35	1.31	
2001	.95	***	.41		.95	1.23	*
2002	.11		.11		.66	.57	
2003	.09	**	.22	**	.52	.44	
2004	.001	***	.00		.54	.54	
2005	.04		-		-	-	

Note: B=composition of spending in Executive budget proposal, L=composition of spending in budget law approved by congress, R=real composition of spending in budget law approved by congress, D=composition of spending in the total executed expenditure. T-tests refer to comparisons between year *t* and year *t+1*. Equality of difference is rejected at: *** 99%, ** 95%, * 90%. Within each year, n=19 expenditure items. For comparability, debt payments have been excluded from the budget.
Source: Data collected by the authors for this paper from congress and the Ministry of Economics and Finance.

Table 9 presents the mean annual budget reallocation by item. It allows comparing whether there was more or less dispersion in reallocations across items over time. Although sample sizes are small (n=19), t-tests of the equality of means comparing year t to year $t+1$ are also reported in the table. Most significant differences concentrate after 1998 and in the approval stage columns (first two columns) and less so at the execution one (last two columns).

We finally examine the effect of three institutional changes on budget reallocations. The three critical moments are the ones described earlier: the 1998 Constitution, the dollarization of the economy, and a sub-moment of the latter, the Fiscal Responsibility Law (FRL). We refer to them as institutional changes.

To test whether each of the institutional changes affected in any systematic way the outcomes of the budget process, we estimate the following reduced-form regression using OLS:

$$CXY_{it} = \alpha + \beta i + \gamma_1 t_1 + \gamma_2 t_2 + \gamma_3 t_3 + \varepsilon_{it}$$

Where *i* and are item fixed effects, t_1, t_2, *and* t_3 are dummy variables that take the value one in the fiscal years following a given institutional change (1999 onwards for the Constitutional reform, 2001 onwards for dollarization, and 2003-2005 for the FRL, respectively) and zero elsewhere, and ε_{it} is an i.i.d. error term. The omitted category for the item variable is *i*=Finance which –as argued earlier- is one of the sectors with the largest fluctuations in its relative share on total spending throughout the budget process.

A positive γ_1, γ_2, or γ_3 indicates whether spending experienced -on average- larger changes at any stage of the budget process after one of the institutional changes, for instance, dollarization. In turn, a positive β would indicate whether –relative to the line item Finance- any given spending item had bigger changes at approval stage.

Table 10 and Table 11 present the results of the estimations. Table 10 focuses on the two dependent variables related to the budget approval stage, while Table 11 focuses on the dependent variables at the execution stage of the budget process. For clarity, we only report the γ parameters, or the effects of institutional changes. Two different models were computed, by including different sets of controls in the regressions. Model 1 includes only the institutional change dummies and Model 2 adds the vector of item dummies.

Table 10. Effect of institutional changes on changes in the composition of expenditure at approval stage of the budget process

	Approved – Presented				Really approved - Presented			
	Model 1		Model 2		Model 1		Model 2	
1998 Constitution	.005	***	.005	***	.002	**	.002	***
Dollarization	-.001	***	-.002	***	-.002	***	-.002	***
FRL	-.005	***	-.005	***	-.001	*	-.001	*
Observations	282		282		265		265	
Adjusted R2	.12		.26		.03		.23	

Note: Dependent variable is |Participation of item *i* at stage *x* – Participation of item *i* at stage *y*|. Model 1 includes only dummy variables that are 1 for all post-change budgets. Model 2 adds item-specific dummies. For comparability, debt payments have been excluded from the budget. Significant at: *** 99%, ** 95%, * 90%.

A first exploration of the tables reveals that the different institutional shocks appear to have not only distinct effects on budget outcomes, but also they seem to matter at different stages of the process. The 1998 Constitution has a positive and significant effect at approval stage. This effect is robust to the different model specifications as well as to the two alternative definitions of the approved budget. However, the effect of the Constitution is insignificant in explaining variation in budget reallocations at execution stages.

Interestingly, The effect of Dollarization and the FRL at approval stage move in the opposite direction to that of the Constitution. These two shocks have negative and significant coefficients, suggesting that, as a response to them, spending experienced -on average- smaller changes at approval stage of the budget process.

Table 11. Effect of institutional changes on changes in the composition of expenditure at execution stage of the budget process

	Executed - Really approved				Executed – Presented			
	Model 1		Model 2		Model 1		Model 2	
1998 Constitution	-.003		-.003		-.002		-.002	
Dollarization	.003	*	.004	**	.003	*	.004	**
FRL	-.003		-.003		-.004		-.004	*
Observations	263		263		263		263	
Adjusted R2	.01		.22		.01		.24	

Note: Dependent variable is |Participation of item *i* at stage *x* – Participation of item *i* at stage *y*|. Model 1 includes only dummy variables that are 1 for all post-change budgets. Model 2 adds item-specific dummies. For comparability, debt payments have been excluded from the budget. Significant at: *** 99%, ** 95%, * 90%.

Interestingly, the sign of the effect of dollarization reverses in the regressions that explain variation in budget reallocation at execution stages. However, the coefficient of the FRL remains negative and borderline significant through these set of regressions. This could be –in part- a result of the short life of the law that manifests in a small number of observations. At the same time, the sign of this coefficient is consistent with the spirit of the law, in that it reduced the power of congress and the Executive to undertake budget reallocations.

The fact that we reject that the effect of dollarization on budget reallocations is equal to zero and negative at approval stage but positive at execution stage provides evidence that extended time horizons and fewer inter temporal constraints on political actors introduced by dollarization encouraged a move towards less budget reallocations at the approval stage but had the opposite effect at execution stage. While the regressions cannot tell us about the forces behind these patterns, it is likely that they relate to the different actors, institutional features, and bargaining mechanisms that come into play at the different stages of the budget process, many of which are discussed throughout this document.

1.3.2. Efficiency in education spending: a case study

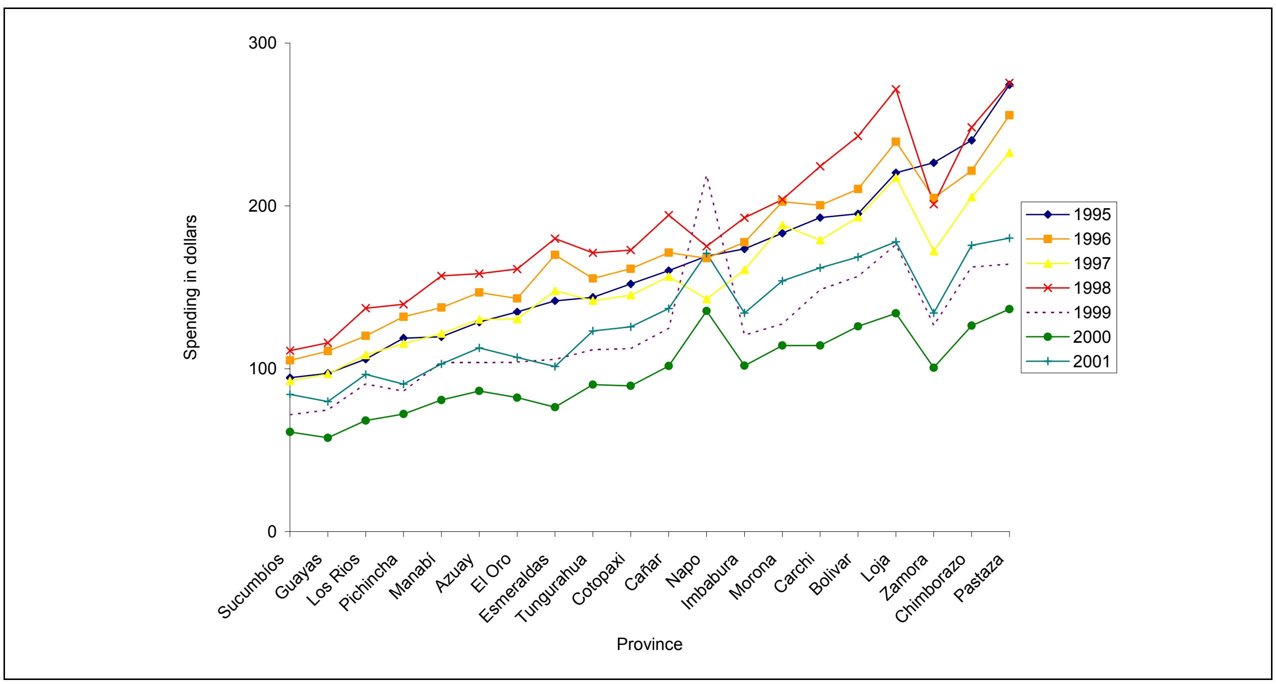
In this section, we explore the allocation of spending in education as a case study to illustrate how, in this particular sector, there were any changes associated to the 1998 Constitutional reform in the efficiency criteria guiding how these resources are used. Figure 8 and Figure 9 summarize some trends of provincial spending in primary education between school years 1995-1996 and 2001-2002. Given that there is data for only one school year after the dollarization of the economy, the analysis of this section will focus on any changes in spending patterns before and after the 1998 Constitutional reform. The available data series consistent over time refer exclusively to Hispanic education, and excludes bilingual education institutions (the Education budget has a separate line item devoted to these schools). Data series on the budget allocated to these schools, as well as the size of the student population and the number of teachers at the province level.

Figure 8 and Figure 9 depict the changes in these associations over time. Figure 8 presents the evolution of per-student spending across provinces, while Figure 9 presents data on spending per teacher. Throughout this section, the province of Galápagos emerges as an outlier that receives significantly larger allocations of money for primary schooling. Since it is likely that the costs of running schools in the sparsely populated islands differ substantially from those elsewhere, this province will be excluded from the graphs and the discussion.

Several patterns are clear from the two graphs. First, while the variation in per student spending across provinces is wide, there is some evidence that it becomes narrower during this period. However, there is not a clear decreasing trend in the dispersion of these variables. Excluding Galápagos, the ratio from the largest-to-smallest per-student provincial spending in 1995 is 2.9 and it goes down to 2.3 by 2001. This ratio experiences a rise in 1999, where it reaches a value of 3.1. An even more erratic pattern is observed in per-teacher provincial spending, where the ratio from the largest-to-smallest value decreases from 1.7 to 1.6 between 1995 and 2001, with a sharp rise to 2.3 in 1999. However, it is positive that the overall range in variation in per-teacher spending is smaller than that in per-student spending. This is indicative that school funding is allocated on the basis of student size and not teacher size, which would create a perverse incentive for schools to hire more teachers than needed.

A second factor is that is clear form the table is that the magnitude of per-student and per-teacher spending in primary education decreases over this period. While again, the decrease is not constant over time, the trend is clearer when comparing the years before and after the 1998 Constitutional reform (i.e. 1995, 1996, 1997, and 1998 vs. 1999, 2000, and 2001). The downward shift in spending is most pronounced in 2000, but recovers substantially afterwards.

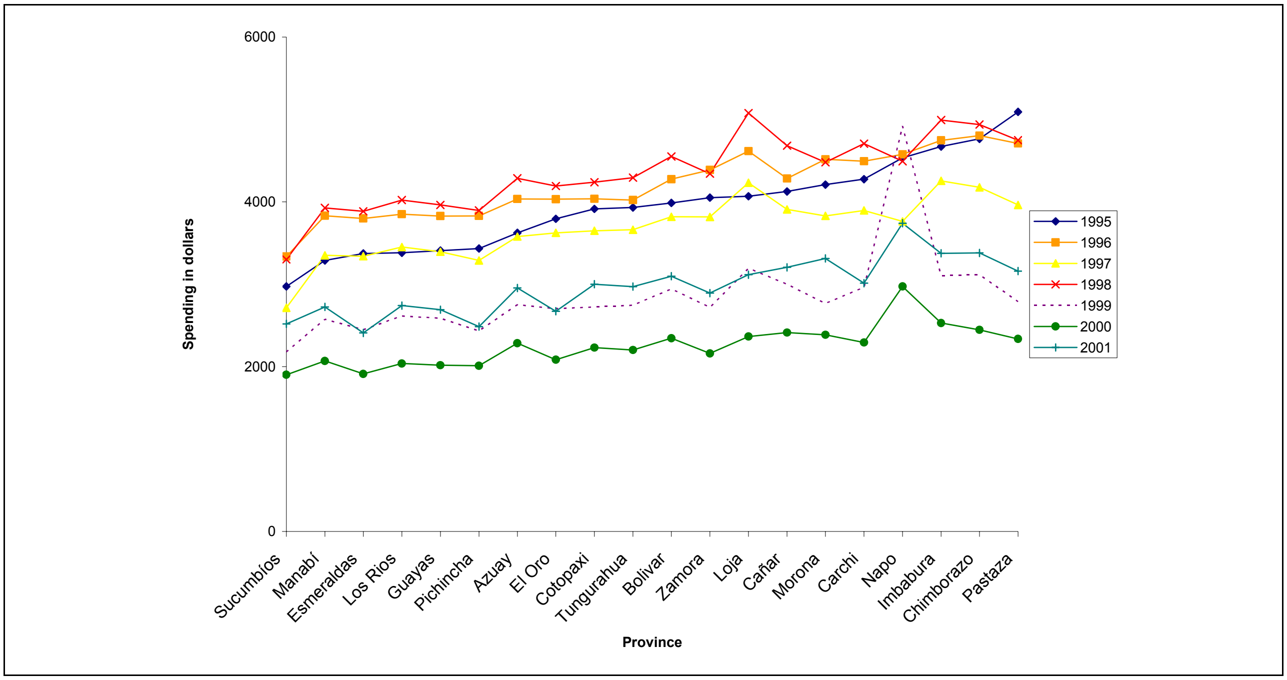
Figure 8: Spending per student, by province (1995-2001)



Note: Figure excludes Galápagos.
Source: Sistema Integrado de Indicadores Sociales del Ecuador, SIISE – 2006.

The third pattern in Figure 8 and Figure 9 is that the ranking in per-student and per-teacher spending across provinces remains relatively stable, with few exceptions. For instance, the province of Napo moves up in the ranking in 1999, while it moves down in 1997. Morona, Loja, Pastaza, and Zamora are the other two provinces that fluctuate in the ranking. The determinants of the success (or lack thereof) of these provinces in receiving larger allocations for primary education could be explored in more detail as case studies.

Figure 9: Spending per teacher, by province (1995-2001)



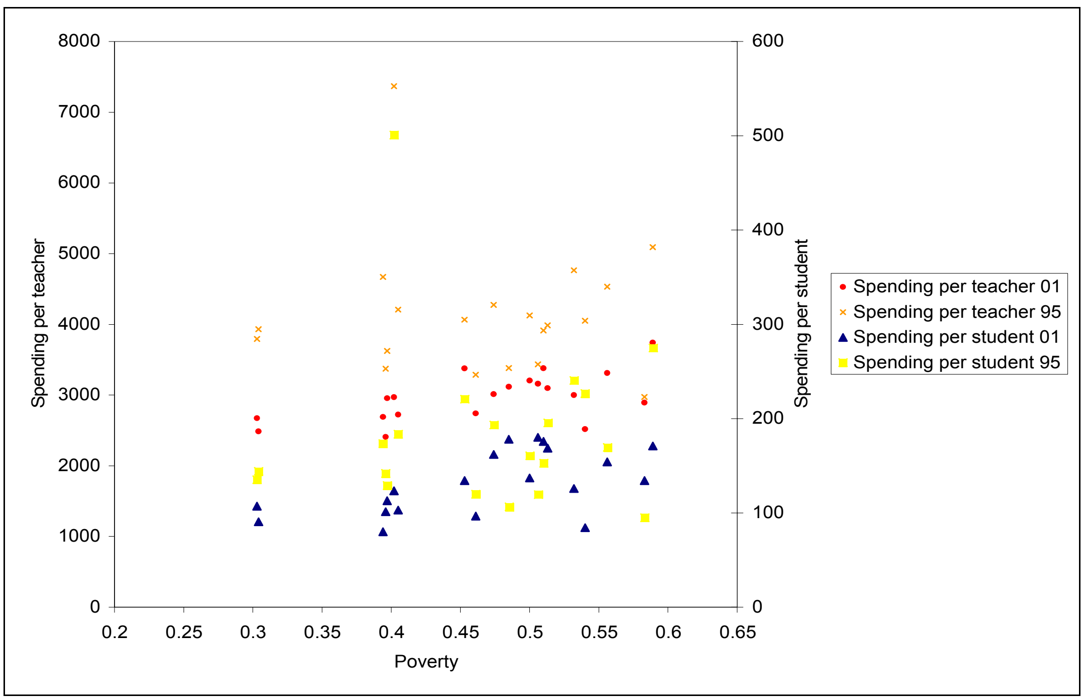
Note: Figure excludes Galápagos.
Source: Sistema Integrado de Indicadores Sociales del Ecuador, SIISE – 2006.

Lastly, Figure 10 illustrates the correlation between per-student and per-teacher spending and provincial poverty in 1990. The data suggest that there have been important changes in the allocation of spending during this period. Specifically, the distribution of primary school spending became more progressive. In 2001, poor provinces received relatively larger allocations for primary education than less poor provinces. This was not the case in 1995. In 2001, the correlation coefficient between poverty and spending per student is .60 and between poverty and spending per teacher, it is 0.57. This represents a large improvement relative to 1995, where the correlation coefficient between poverty and spending per student was .02 and between poverty and spending per teacher, it was -0.05. Interestingly, Galápagos is the only province that moved in the opposite direction: during this period, its spending (both per student and per teacher) diverted away from the rest of the distribution.

Based on the above observations, there are five patterns that emerge from the changes in education spending during this period. First, variation in per-student (and per-teacher) allocations across provinces seems to decrease, but the variable moves erratically. Second, it seems that funding allocation gives the right incentives to schools by making them proportional to student (rather than teacher) size. Third, spending in primary education experiences a decrease in magnitude during the period studied. Fourth, there are few changes in the ranking of provinces in terms of the relative allocations they receive. And lastly, spending in primary education appears to move towards a more progressive trend.

These indicators seem to support that allocation of resources in this sector moved closer to a more equitable and efficient path in the period of study by this paper. However, efficiency in resource allocation has not translated in better educational outcomes. Data from the last two population censuses demonstrates that despite all the investments in the sector, the net enrollment ratio remained constant between 1990 and 2001. There are no series of standardized test scores that can produce comparable measures of other educational outcomes. What we conclude from these facts is that investments in educational inputs and school construction are necessary but not sufficient to improve schooling outcomes. International experience suggests that improvements in teachers' and students' attendance, school accountability, and quality of instruction are usually more difficult to accomplish, but are fundamental in improving the quality of education. Beyond the supply-side, demand side interventions such as fellowships or conditional cash transfers have also proven to be effective (in Ecuador and elsewhere) in producing better educational outcomes.

Figure 10: Primary education spending and poverty in 1995 and 2001



Note: Figure excludes Galápagos.
Source: Sistema Integrado de Indicadores Sociales del Ecuador, SIISE – 2006. Poverty data is from 1990 Ecuador Poverty Map prepared by the World Bank (Elbers et al. 2002).

6.3 Representativity of budget outcomes

As developed in section 3.1 the 1998 Constitution and related reforms adopted significant electoral changes that affected the level and quality of representation. This section measures the magnitude and direction of such changes and their impact on the representativity of budget outcomes, measured as the province-level of per capita spending.[81] The data presented compares spending outcomes of budgets before and after the 1998 constitutional reform (1997 and 2004, respectively). Data on provincial spending was available only for two years prior to the implementation of the constitutional reform: 1997 and 1998. 1997 was chosen as a benchmark year because the economy was more stable than in 1998. Moreover, a new government took office in1998, making this a more peculiar year.

The section starts with a sequence of descriptive statistics, or a discussion of the observed changes in the main variables of interest including per capita spending across provinces and political variables before and after the 1998 Constitution. After discussing bivariate variations, we attempt to disentangle their relative importance using multivariate analysis. The section concludes with a brief exploration of the relationship between representativity of budget outcomes and poverty.

Per capita provincial spending and its changes between 1997-2004

Figure 11 depicts the large dispersion in per capita spending across provinces. It also demonstrates that spending in per capita terms is inversely correlated to population size. These are not surprising findings by themselves, as differences in spending could be explained by differences in provinces' needs (or poverty in 1990) as well as by differences in their characteristics (geographic, ethnic, historic, and other), or by the presence of economies of scale in the provision of services in areas with higher population densities. Galápagos is a clear outlier in this distribution, and the differences are likely to be due to its very unique attributes.

Figure 11 seems consistent with a relatively progressive pattern of spending, where provinces that are poorer receive more resources on a per capita basis. The graph illustrates that there are two clusters of provinces. Excluding Galápagos, provinces that are below median poverty are also likely to have lower levels of per capita expenditure. The opposite is true for provinces above median poverty. However, this apparently progressive pattern of spending is not clear cut and this suggests that the distribution of spending across provinces is a product of more complex policy decisions and tradeoffs. For example, while per capita expenditure (and population sizes) is similar between pairs of provinces such as Cotopaxi-Imbabura and Chimborazo-Esmeraldas, poverty is 17% (or 8 percentage points) higher in Cotopaxi than in Imbabura and 29% (or 11 percentage points) higher in Chimborazo than in Esmeraldas. This section sheds light on some of the political factors that may be affecting the allocation of spending across provinces.

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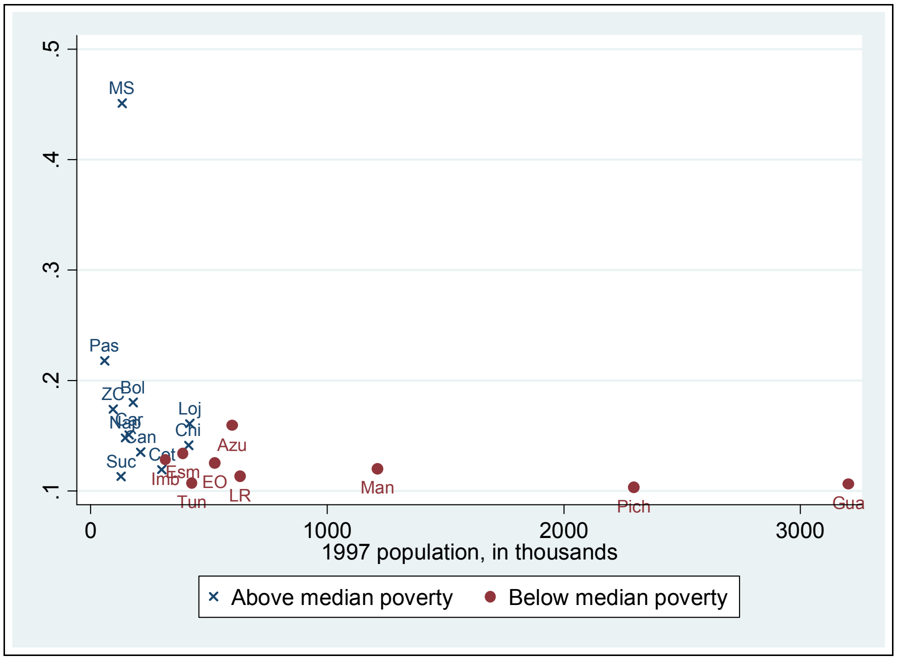
[81] For details on definitions and description of provincial-level spending data used, see Albornoz, Vicente. 2000. *Gobierno Central, Autonomías y Finanzas Provinciales*, Cuadernos de Descentralización, CORDES, Quito-Ecuador. The 2004 data were collected for this study maintaining consistency in the definitions used in 1997.

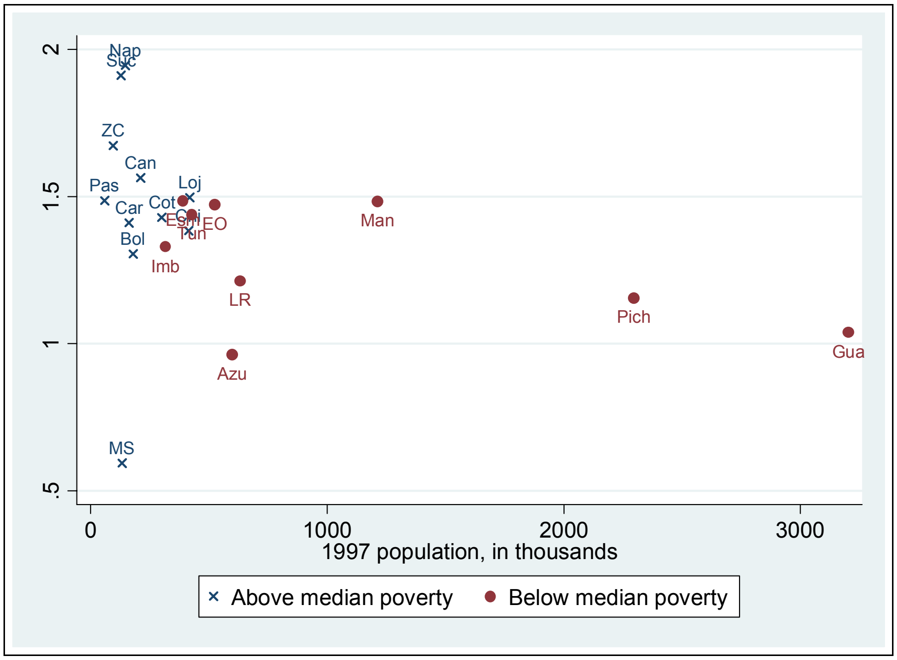
Figure 11: Per capita expenditure and province size in 1997



Note: Galápagos is not included in figure.
Sources: Provincial expenditure data from Albornoz (2000) and from data collected by the authors for this study. Population data from INEC. Poverty data from 1990 poverty map constructed by the World Bank (Elbers et al., 2002).

Figure 12 illustrates the changes in per capita expenditure between 1997 and 2004. Each dot represents one province. In the vertical axis, we depict the ratio of the 2004 per capita expenditure over that in 1997. The horizontal axis illustrates province size in terms of population. This figure also distinguishes across provinces above and below median provincial poverty. The ratio of 2004 to 1997 spending and population size are negatively associated, suggesting that smaller provinces (in terms of population) saw *larger* increases in per capita spending over this period. Based on the chosen measure for the representativity of budget outcomes, this trend demonstrates over the period, budget outcomes moved in the direction of being less representative. When comparing whether larger increases in spending are correlated to provinces' poverty, the answer is less clear. A few large provinces with lower poverty rates such as Pichincha, Guayas and Azuay saw smaller increases in per capita spending while a few small provinces with higher poverty such as Napo and Sucumbíos saw higher increases. However, for the rest of the provinces (more than three quarters of them), there no clear association between poverty and increases in per capita spending can be inferred from the graph.

Figure 12: 2004-1997 changes in per capita expenditure and province size



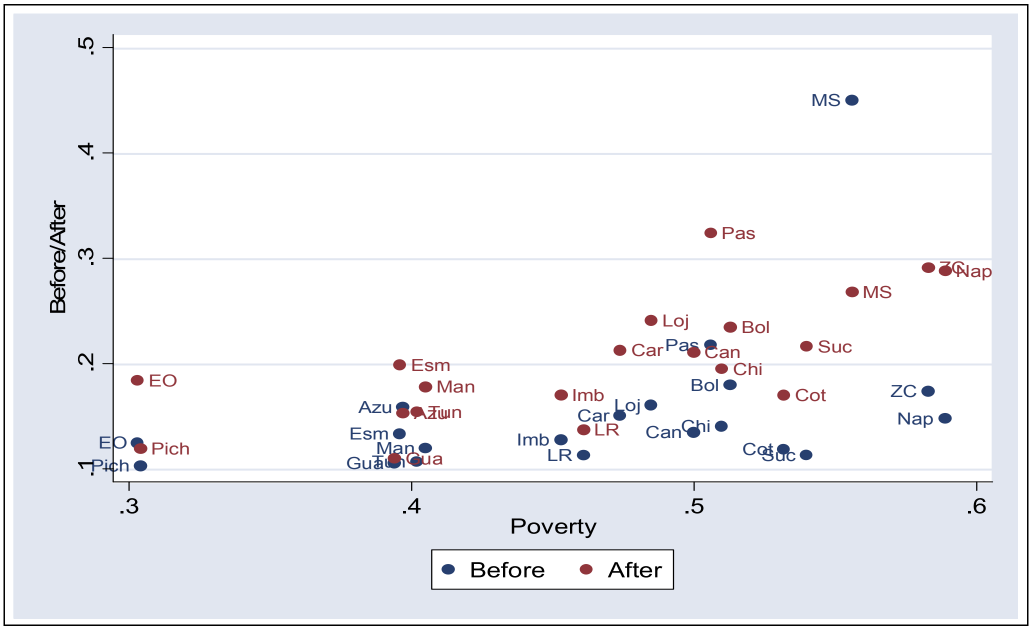
Note: Galápagos is not included in figure.
Sources: Provincial expenditure data from Albornoz (2000) and from data collected by the authors for this study. Population data from INEC. Poverty data from 1990 poverty map constructed by the World Bank.

Given the large heterogeneity in terms of population across Ecuadorian provinces, per capita expenditure can tell an imperfect story about representativity of expenditure. To complement this discussion, the next figure illustrates the association between provincial per capita expenditure and provincial poverty.

Figure 13 depicts per capita provincial spending before and after the 1998 Constitution in the vertical axis and poverty in the horizontal axis. Provincial level poverty is measured in 1990. Provincial poverty data is only available for 1990 and 2001. 1990 was chosen as a benchmark year for the poverty data, as any effects on poverty of subsequent economic and political reforms would not be reflected.

Figure 13 illustrates there is a positive association between expenditure and poverty: per capita expenditure is larger in relative terms in those provinces where poverty was higher, (which is worth noticing are also smaller provinces in terms of population). This positive association is observed before and after the 1998 reform. What is more interesting is that after the 1998 reform, the trend line appears to become steeper. This suggests that for a given increase in poverty, the difference in per capita expenditure has become wider. As long as this effect is more pronounced among poorer provinces, it can be suggestive of some type of progressivity in spending. This could provide an alternative lense to look at changes in the representativeness of spending.

Figure 13: Provincial expenditure and poverty before and after 1998 reform



Note: For clarity, figure excludes Galápagos. Poverty figures correspond to 1990.
Sources: Provincial expenditure data from Albornoz (2000) and from data collected by the authors for this study. Poverty data from 1990 Poverty Map prepared by the World Bank (Elbers et al. 2002).

Post-1998 institutional reforms

As explained by sections 4.1, and 6.3-4, many institutional reforms introduced after 1998 significantly altered the electoral dynamics in Ecuador. Electoral reforms were adopted to elect legislators through a personalized vote, first by simple plurality (1998) and then through some form of proportional representation rule (2000, 2002). Secondly, the total number of legislators was increased from 82 in 1996 to 100 in 2002 *and* the election of national legislators was eliminated.[82] In theory, these changes should have encouraged legislators to cultivate personal and local followings as opposed to being responsive to their party leaderships, and contribute to the proliferation of political parties and the fragmentation of the legislative landscape. From the presidents' perspective, these should have contributed to an increase in transaction costs for forming budget coalitions, since more fragmented and provincial players were involved in the budget process.

One useful measure of equity in the electoral representation is captured by the concept of malapportionment, defined as the discrepancy between the share of legislative seats and the share of population held by geographical units (Samuels and Snyder 2001). The measure of malapportionment illustrates deviations from the democratic "one man one vote" principle and it shows differences in the relative weights of citizens' votes across districts.[83]

[82] The 1998 congress elected 121 members, 20 of which were national. In theory, this should have been the most proportional congress of recent years, but it is not included in this analysis because such arrangement only lasted until 2002.
[83] The formula for calculating aggregate malapportionment is:

It is possible to track the evolution of provincial malapportionment in the periods before and after the 1998 Constitution. The malapportionment measure computed at the provincial level suggests that the Constitution led to a very small decrease in malapportionment (mean malapportionment went down from 41 to 37 and the difference is not significantly different from zero). This means that the reform had a minuscule effect in terms of it magnitude. The direction of this effect was towards the reduction the relative weight of a vote in all but four relatively small provinces (Bolivar, Cañar, Carchi, and Napo). This change could be consistent with the decrease in representativeness of budget outcomes that was observed after the reform. Moreover, the effect of the 1998 constitutional reform on budget outcomes cannot be disentangled with another important reform that occurred during this period: the implementation of a decentralization law that mandated that 15 percent of all government spending had to be distributed across sub national governments. This could potentially reinforce the decrease in representativeness of budget outcomes if smaller provinces (in population terms) were also the ones that benefited relatively more in per capita terms from the decentralization law.

6.4 Adaptability / rigidity of Budget Outcomes

The budgetary rigidity comes from factors that limit the government's capacity to modify its budget in the short run. When analyzed from this perspective, the rigidity in Ecuador's fiscal budget presents itself in various ways. Those which are most known are earmarks and a high salary component (as seen in section 6.1), but there are also other types of inflexibilities such as expenditure that is conditioned or tied to specific projects or subsidies. The high rigidity in the budget turns fiscal policy-making more difficult and creates a bias towards spending. Furthermore, it negatively impacts the quality of public expenditure and has other effects that are beyond the boundaries of this study to analyze. To the extent possible, Ecuador's budget rigidity is measured in this section and some of recent reforms in this direction are outlined.

The main conclusions are that Ecuador has a high budgetary rigidity and than it has only gotten worse since 1998. During that year, earmarks for sectional governments rose up to constitutional level and the earmark for education was maintained. In 2001, an option to donate income taxes to other sources was established.

1.7.1 Rigidity in the Central Government's Budget

The Central Government's Budget presents a 92% of inflexibility[84] due to the existence of: i) earmarks; ii) wages; iii) subsidies; iv) expenditure tied to specific projects; and v) interest payments on foreign debt.

$$MAL = (1/2)\,\Sigma\,|\,s_i - v_i\,|$$

where sigma stands for the summation over all districts i, s_i is the percentage of all seats allocated to district i, and v_i is the percentage of the overall population (or registered voters) residing in district i. In this paper we calculate the ratio between a district's population and the seat share obtained in congress for each province. In the case of congresses with "National Legislators", we add the district's provincial seats to the province's share of national legislators.

[84] Almeida 2005.

The Ecuadorian budget does not show all real revenues and expenditures because there are certain earmarked revenues that are handed directly to the beneficiaries before they enter the National Treasure. Additionally, certain expenditures such as subsidies to domestic gas and gasoline are already accounted for as costs for Petroecuador, the state oil company, so they are subtracted from total oil revenues before these are registered in the budget.

6.4.1 Earmarks

Earmarks are revenues and expenditures that are legally predestined[85] to a specific source and were created as a means for the Legislative branch to ensure the allocation of resources to determined programs or institutions and offset their lack of formal access to the budget.[86]

Although legally they should not exist, in practice they are maintained. The Budget Law mandates respect for unity and universality principles,[87] and specifically prohibits earmarked expenditures,[88] or at least limits them to be received after they have been technically justified. [89] The Constitution, nevertheless, determines that 30% of the GGB must be destined to education.[90]

Those earmarks that distribute resources from oil and tax revenues to the beneficiaries before those funds enter the budget are known as "earmarks on revenues", while pre-assigned revenues that have already been registered in the budget are called "earmarks on expenditures" (Table 13).

The 2006 Central Government's budget proposal includes only US$262.8 million in the GGB, the rest is, in part, in the budgets of autonomous entities and another part is directly transferred to public entities and organizations, such as sectional organizations.[91]

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[85] Gallardo 2001.
[86] Almeida 2005.
[87] Art. 4.
[88] Art. 6.
[89] Art. 7.
[90] Art. 71.
[91] MEF, Central Government's 2006 budget proposal.

Table 12. Earmark Classification

	Type of earmark	# of earmarks	Total in 2006 US$ million
Revenue	Tax	32	1,002.57
	Oil	25	726.94
Expenditure	Compensations		
	Laws for Sectional Governments	15% for Municipalities, Provincial Governments and 2 additional legal bodies	
	Other	Expenditures established by Law but that do not have financing	

Source: Gallardo 2001.

6.4.2 Earmarks on revenues

The budget proposal for 2006 shows that 79.15% of total tax collections were supposed to become part of the budget while 20.9% was to be distributed among different actors. The main beneficiaries of tax revenue earmarks are universities and sectional governments (Figure 14 and Figure 15), Income tax and Value Added Tax (VAT) providing with the most resources to hand to participants.

Figure 14: Earmarks on tax revenues

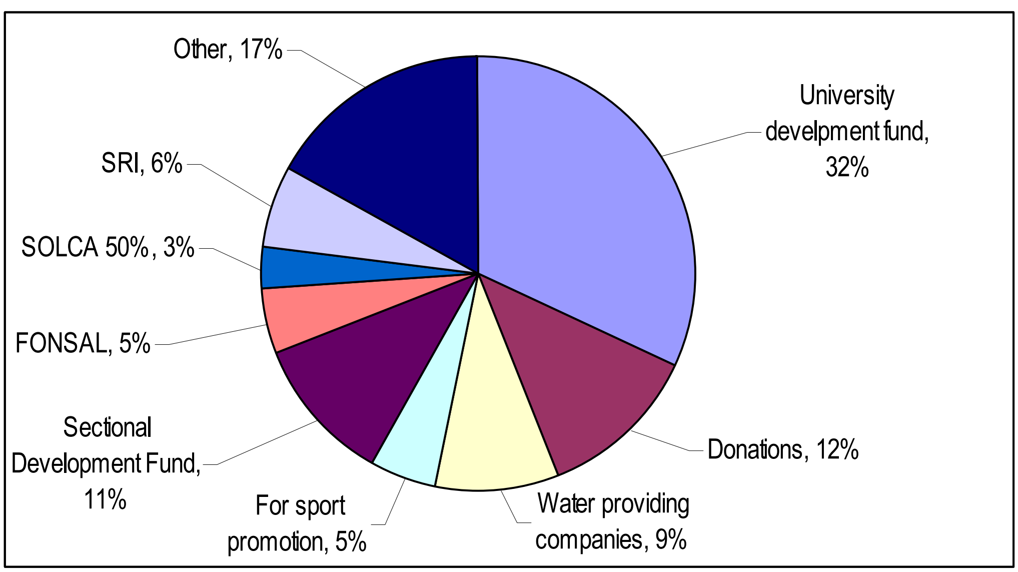
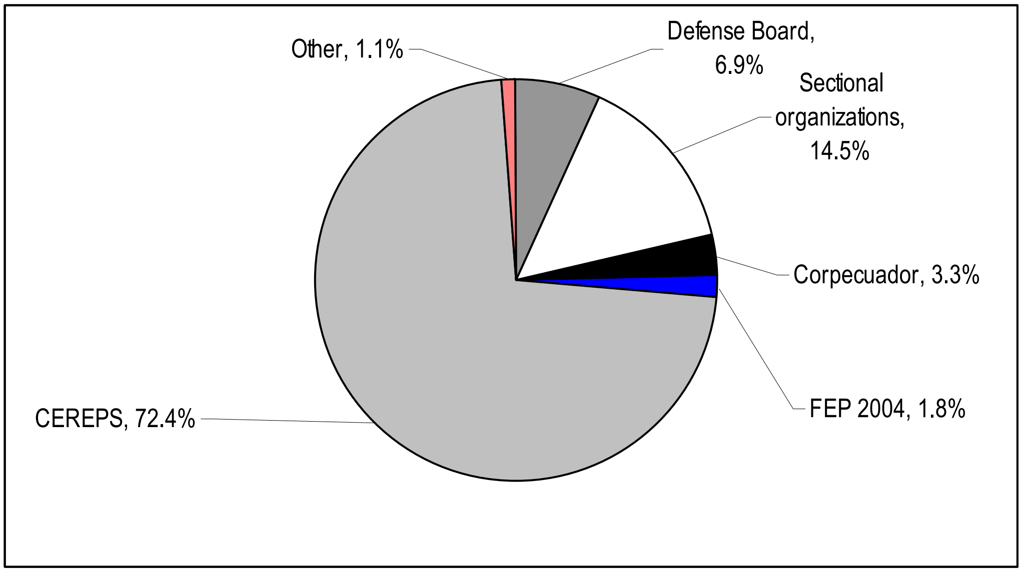


Figure 15: Earmarks on Oil Revenues



Source: MEF, 2006 budget proposal

Earmarks on oil revenues represent 14.52% of total oil revenues.[92] The Fiscal Responsibility, Stabilization and Transparency Law determines that all state revenues from participation in crude oil of up to 23° API from exploration and exploitation contracts have to be deposited in a special account called Special Account for Social and Productive Reactivation, Scientific and Technological Development and Fiscal Stabilization (CEREPS). Part of the resources from the CEREPS are marked as a predetermined transfer of capital to Central Government entities (US$ 184.5 million for education; US$ 158 million for health and US$26.3 million for road maintenance), the rest of the resources from this earmark are part of the budgets of autonomous and decentralized entities. The main beneficiaries from earmarks in oil revenues, aside from those assigned through the CEREPS, are sectional organizations, specifically the Institute for Amazonian Regional Eco-development –ECORAE- (13.2% of total earmarks on oil revenues), the Board of Defense (6.9%) and the Executive Corporation for the Reconstruction of Zones Affected by El Niño –Corpecuador- (3.3%).

When oil revenues turn out to be larger than originally budgeted, they are transferred to the Oil Stabilization Fund (Fondo de Estabilización Petrolero – FEP), that is an account managed by the Central Bank. For the purposes of the State General Budget, oil revenues are defined as those from exports of oil and its sub-products as well as those from their domestic sales. Revenues from domestic sales of oil sub-products are net of production costs and of costs of imports of gasoline and diesel, which are imported when the capacity of national refineries is not enough to supply the domestic market.

At the end of every year, the Central Bank liquidates the FEP and distributes it accordingly to the following rule:

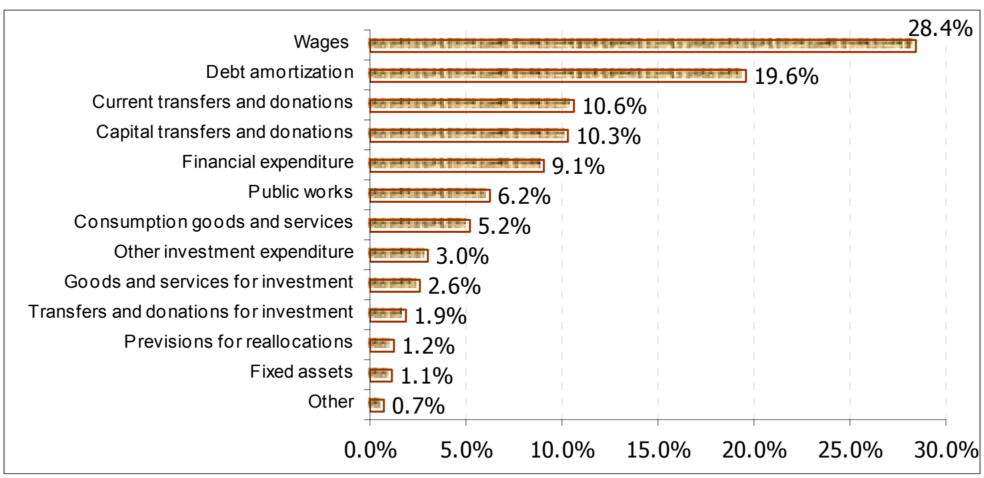
[92] MEF, Central Government's 2006 budget proposal .

1. The Central Government receives enough resources to cover for the budgeted oil revenues. In the last years it was often the case that revenues from exports were above what was budgeted, while the revenues from domestic sales were below those budgeted. In such a case, the surplus of the former covers for the shortfall of the latter and the government receives the amount that it had expected to receive.
2. If there is still a surplus after distributing the resources described above, it is allocated with the following criteria: 45% for the management of liabilities; 35% for maintenance and pavement of a highway in the main oil producing region (the vía Troncal Amazónica); 10% to finance development projects in the provinces of Esmeraldas, Loja, Carchi, El Oro, and Galápagos; and 10% for equipment and strengthening of the national police. This means that 100% of the surplus oil revenues are earmarked.

6.4.3 Earmarks on expenditures

Aside from earmarks on revenues, there are fixed and inflexible expenditures such as wages; earmarks and compensations on expenditures; subsidies; projects with domestic and foreign debt; and foreign debt interest payments[93] (Figure 16).

Figure 16: 2006 Fiscal Budget by Expenditure



Source: MEF, 2006 budget

According to the MEF, there are 303,239 public servants, whose wages and salaries represent 28.4% of total expenditures. Out of the total budget estimates of expenditures on wages and salaries, 74.2% is concentrated in the following sectors: Education (39.4%), National Defense (20.8%) and Internal Affairs and Police (14%).

Resources transferred to sectional governments are the main source of outflows in expenditure earmarks, including a Law requiring a 15% transfer to municipalities and provincial governments, FODESEC and FONDEPRO.

[93] Almeida, Gallardo, Tomaselli; Gobernabilidad Fiscal en Ecuador, July 2005.

6.4.4 Subsidies and transfers

Another set of budget inflexibilities is comprised of various subsidies within the budget, such as the BDH program (a targeted conditional cash-transfer program that benefits over a million families), transfers to social security institutions, subsidies to the electricity sector and the public financial sector, among others.

7 Summary and Conclusion

Ecuador offers an interesting case study to analyze –from a political economy perspective- the impact of major political and economic reforms on the budget process and, consequently, on budget outcomes. The focus on budget outcomes reflects this paper's concern to find a comprehensive account of the changing incentives for cooperation that budget players have under different political and budgetary arrangements.

The paper finds that the set of constitutional reforms adopted in 1998 and other political reforms adopted in previous years (1996-1998) offered relevant budget players a contradictory set of incentives for cooperation. On the one hand, they gave legislators incentives to be more responsive and accountable to their constituents by allowing them to seek reelection and stay longer terms in office, and by strengthening the role of the budget committee in the congress. On the other hand, it constricted the role of congress in the general budget process, by giving the executive greater agenda setting power over formulation and execution, and by banning legislators from accessing or negotiating budget allocations for provinces. In the end, the greater agenda setting powers of the executive contributed to more sustainability of the budget process. From a political standpoint, the budget became less efficient as more budget reallocations took place during approval stage. Despite some important electoral reforms aimed at adjusting the proportionality of the electoral system, the budget did not become more representative. And finally, constitutional reforms contributed to greater earmarking and therefore more rigid (less flexible) budget outcomes.

Dollarization reforms and the associated adoption of a Fiscal Responsibility Law significantly constrained the choice of fiscal policy instruments available to governments. Dollarization imposed a de facto need for fiscal discipline as the government could no longer print money. By eliminating the role of the monetary authority, dollarization also contributed to shifting policy choices to the legislative arena, where policy change has been traditionally rigid. At the same time, a rise in international oil prices and therefore an increase in oil revenues also contributed to more budget rigidity by encouraging further earmarking of oil reserve funds. On a more positive light, dollarization contributed to greater budget sustainability, and greater efficiency (i.e. fewer) budget reallocations, especially during execution stage. Again, these two effects have to be considered in the context of increasing oil prices and moderate economic growth.

Although this paper does not calculate the net effect of the two types of reforms on budget outcomes, the overall effect indicates that current budget outcomes have become more sustainable and efficient, although less representative and adaptable to changing needs. In other words, the observed budget outcomes suggests that political and economic reforms have pushed in the direction of greater budget governance, though at the expense of marginalizing key players such as the national congress.

This paper proposes that the budget outcomes resulting from the existing institutional configuration are outside an equilibrium path, and thus are not sustainable in the long run. A closer look at budget dynamics finds that relevant players do not have incentives to sustain political agreements over the long run because of existing asymmetries in the balance of power (weak legislature combined with a strong executive and sub national government), and the continued presence of windfall oil revenues that dissolve actors' incentives for budget discipline.

A clear example of this unstable equilibrium is the short-lived Fiscal Responsibility Law (FRL). The Law, initially approved in 2002, was designed to prevent increases in oil revenues from expanding expenditure. The law was approved in a period when there were expectations that oil production and revenues would increase due to the construction of a new oil pipe. Furthermore, the effects of the 1999 economic crisis were still fresh in the memories of congressmen and of the general public. In this context, it was possible for the government to build an agreement around a set of principles of fiscal responsibility and to find enough support for congress to pass the law. Congress approved the FRL under the understanding that it would come into effect *with the new government and the new congress* that were to begin their term in 2003. Therefore, neither the congress nor the executive imposed the spending constraints from the FRL upon themselves during their terms and their (potential) reelection campaigns. By 2005, the reality of international oil markets had changed dramatically. In that context, a discourse of opposition to expenditure constraints imposed by the FRL gained popularity. Following a proposal from the executive, congress profoundly modified –and de facto derogated- the basic principles of the FRL. This reform came into effect immediately, which meant that resources for public spending were liberated *just before the approval of the next state budget.* Therefore, both congress and the executive benefited directly from more lax fiscal rules during their terms and their (potential) reelection campaigns. Furthermore, the same political parties that supported the approval of the FRL in 2003 were the ones that, in 2005, voted to reform it.

The story of the FRL –both during its approval and its reform- illustrates the point that shifts in policy priorities remain vulnerable to short-term incentives from both congress and the executive. Furthermore, in both moments political actors protected their own potential gains from the budget process and passed-on the costs of their policy decisions to their successors. This behavior is not consistent with the long-term health of fiscal finances and illustrates our argument that the current –apparently healthier- budget outcomes are politically unsustainable.

Finally, there are two elements of the current budget process that deserve further analysis: the shifting of the budget dynamics from the national to the sub national arena, and the impact of rising oil revenues on political cooperation.

The first one of these elements, the shift of budget politics from the national to the local sphere, is a combined effect of two events that resulted from the 1998 constitutional reforms. On the one hand, there is a deliberate effort from the executive to weaken and undermine the influence of congress in the budget process since 1995. Although politicians become more "accountable" to their voters, they gradually lose access to budget allocations and other legal means for delivering constituency services. Frustrated legislators are left with very few options to influence on the policymaking process and advance their political careers: they could radically oppose government initiatives, they could find clandestine mechanisms for allocating resources, or they could leave the congress in search of more attractive political arenas. Concurrently, there is a gradual strengthening of local governments caused by the constitutional allocation of greater resources (an earmarking of 15% of government spending), plus the adoption of other legal and technical reforms (such as the Ley Organica de Regimen Municipal) that gave them greater autonomy from the central government and increased influence on the budget making process. This paper proposes that politicians find clear political incentives to move from a resource-dry policy arena to a policy realm where they enjoy abundant resources, more discretionality, and clearer electoral links with their constituents. This movement is echoed by national political parties who find in the sub national arena the governability incentives and credibility that they lack at the national level.

The second element that deserves further analysis has to do with the high dependency of the economy on oil revenues and the practice of earmarking the budget. During periods of low oil prices, scarce revenues have a direct negative impact on fiscal performance that non-oil revenues cannot compensate for. During boom periods, increased oil revenues create incentives for further fiscal spending. The greater agenda setting power of the president on budgetary affairs, which is generally considered a contributing factor to fiscal discipline, becomes a liability as there are multiple incentives to invest oil monies for political gain. A similar logic applies to explaining the volatility of oil stabilization funds. In a context of rigid budget rules and significant earmarking, rising oil revenues increase the budgetary constraint and reduce political incentives for fiscal discipline.

A more comprehensive analysis of these elements is necessary to gain a better understanding of the impact of political institutions on budget outcomes in the volatile Ecuadorian environment.

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8.2 Datasets

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Indicators from OECD-IDB-WB Budget Survey Project

Monthly Statistical Information from the Central Bank of Ecuador

Development Data Platform time series data from the World Bank

Ecuador 1990 and 2001 poverty maps prepared by the World Bank

Ecuador 1990 and 2001 population censuses from Instituto Nacional de Estadística y Censos - INEC

Sistema Integrado de Indicadores Sociales del Ecuador SIISE, 2006

Annex 1. Measuring Changes in the Composition of Spending

(Scartascini and Stein 2005)

Define the total changes in the composition of spending between stages X and Y of the budget process, CXY as:

$$CXY = \sum_{i=1}^{N} CXY_i$$

where $i=1,...N$ are the spending items and:

$$CXY_i = \frac{|X_i - Y_i|}{2}$$

where X_i and Y_i are the shares of item i on total spending at the stages X and Y of the budget process, respectively. Therefore CXY_i can be interpreted as the item-specific changes in the XY phases. Following the notation in Scartascini and Stein, we focus on the following phases of the budget process (or Xs and Ys):

B= Executive budget proposal,
L= budget law approved by congress,
R= real budget law approved by congress,
D= total executed expenditure.

The inclusion of phase R deserves an explanation. After the adoption of the 1998 Constitution, increases in total spending (or reductions in revenues) at approval stage were no longer possible (see table 3). Therefore, the only way of increasing expenditure of one specific budget item was to decrease spending of another one. What we observe is that after 1998, at approval stage, congress agrees on a list of changes to the budget proposal sent by the Executive (in words) that are reflected in the formal budget law that is approved. However, faced with formal constraints to increase spending, we argue that legislators mask alternative allocations that further their political interest under the formal budget law. For example, the budget law may decrease interest payments while increasing social spending. In practice, those interests correspond to compromises acquired by the country that need to be repaid. What this "reallocation" means is a *de facto* increase in total spending.

To construct phase R, what we call the *real* budget law approved by congress, we went over the list of changes to the budgets approved by congress every year and did an interpretation of their implications in terms of budget. Not all budget items experienced changes when these corrections were made. In fact, 75% of the item-year records remained unchanged, while 7% decreased and 18% increased in magnitude. In terms of total spending, the R correction shows that the budget law masked an increase in total spending at approval stage for all years except 1999 and 2004. The first of these years, 1999, is also the first year immediately after the approval of the Constitution (and the first budget whose approval was legislated by it), which was probably in the steep part of the "learning curve" in terms of the constraints and limitations imposed to congress of this new piece of legislation. 2004 is also a unique year. The budget was approved in October 2003, when the government of president Gutiérrez did not face strong opposition in congress and the Minister of Finance gained support from the president and from congress for an austere budget.