

# **CONTENTS**

Abstract	ix
Acknowledgments	xi
Abbreviations and Acronyms	xv
Executive Summary	xxi
Fiscal Policy Faces Historical and Structural Constraints	xxii
Fiscal Trends and Challenges	xxiii
Pro-Poor Expenditure and the Room for Additional Fiscal Space	xxv
Public Expenditure Management (PEM) and Other Institutional Issues	xxviii
Conclusions and Policy Recommendations	xxx
A Selection of Key Policy Recommendations	xxxiv
1. Fiscal Policy in a Dollarized Economy	1
The Ecuadorian Economy: Some Historical Background	2
The Role of Fiscal Policy in a Dollarized Framework	4
Structural Constraints on Fiscal Policy	6
2. Fiscal Trends and Challenges	11
The Volatility of Fiscal Variables	11
Fiscal Performance Before and After Dollarization	11
The Challenge of Revenue Management	14
Fragmented Tax Structure	15
Tax Exemptions and the Erosion of the Tax Base	17
Earmarking: The Undermining of Budget Flexibility	17
Expenditure Trends	17
The Fiscal Transparency, Stabilization and Responsibility Law	26
Stabilization Funds	26
Fine-Tuning Fiscal Rules	28
Issues in Debt Sustainability	31
Exercise 1. Fiscal Sustainability under a Sudden Drop in the Price of Oil, Surge in Interest Rate, or Capital Outflows	33
Exercise 2. Fiscal Sustainability under Tax Revenue Volatility	34
Policy Recommendations	34
3. Pro-Poor Expenditures and the Fiscal Space	39
Is Social Expenditure Enough for Poverty Reduction?	40
Is Social and Basic Infrastructure Expenditure Pro-Poor?	42
Main Social Programs	42
Subsidies in Basic Infrastructure Services	49
How Much Fiscal Space Is Available for a Poverty Reduction Strategy	52
Reversing Current Expenditure	52

Making an Optimal Selection of Public Investment . . . . .	54
Assessing Defense Spending . . . . .	55
How Much Off-Budget Fiscal Space Can Be Found for a Poverty Reduction Strategy . . . . .	56
Freezing or Reducing Budget Earmarking . . . . .	56
Reducing Tax Expenditure . . . . .	57
Making Transparent and Intergrating Off-Budget Public Investment . . . . .	59
Towards a Results-Oriented Budget: Attaining the Millennium Development Goals . . . . .	59
Policy Recommendations . . . . .	64
To Shift Public Expenditures Toward a Pro-Poor Focus . . . . .	65
To Re-Target Public Subsidies . . . . .	66
Trade-Offs Between In- and Off-Budget Fiscal Space . . . . .	68
To Reach Selected MDGs . . . . .	69
<b>4. Performance of Public Expenditure Management . . . . .</b>	<b>71</b>
The PEM Process and its Recent Performance . . . . .	72
Budget Management Review in the Central Government . . . . .	74
Budget Formulation . . . . .	74
Execution . . . . .	79
Budget Management Review in Social Programs and Subnational Governments . . . . .	84
Social Programs . . . . .	84
Provincial and Municipal Governments . . . . .	90
Budget Transparency, Accountability, and Participation . . . . .	94
Are There Sufficient Conditions for a Multiyear Budgeting Framework in Ecuador? . . . . .	97
Policy Recommendations . . . . .	98
<b>APPENDIX A. An Estimation of the Potential Output     And the Structural Fiscal Balance in Ecuador . . . . .</b>	<b>105</b>
<b>APPENDIX B. Summary of the Budget Process . . . . .</b>	<b>111</b>
<b>APPENDIX C. Major Budgetary Issues in Priority Social Programs . . . . .</b>	<b>115</b>
<b>APPENDIX D. Budgetary Framework of Decentralization in Ecuador . . . . .</b>	<b>127</b>
<b>APPENDIX E. Budgetary Framework of Decentralization in Ecuador . . . . .</b>	<b>137</b>
<b>STATISTICAL APPENDIX . . . . .</b>	<b>143</b>
<b>BIBLIOGRAPHY . . . . .</b>	<b>239</b>

## **LIST OF TABLES**

ES.1	Potential Sources of Fiscal Space and Estimated Annual Impact . . . . .	xxviii
2.1	Volatility of NFPS Variables, 1993–2003 . . . . .	12
2.2	Ecuador: Actual and Structural Fiscal Balance, Fiscal Stance and Fiscal Impulse . . . . .	13
2.3	Total Revenue of the Non-Financial Public Sector and Central Government . . . . .	15
2.4	The Structure of the Tax System . . . . .	16
2.5	Selected Tax Administration Indicators, 2001–03 . . . . .	16

2.6	“Optimal” Fund vs FEIREP Flows for Debt Reduction . . . . .	29
2.7	Evaluation of Compliance with the Fiscal Rules . . . . .	30
3.1	Ecuador: Social Expenditure of Central Government as a Percentage of GDP . . . . .	41
3.2	Pro-Poor and Non Pro-Poor Social Expenditures. . . . .	43
3.3	Social Expenditure and Energy Subsidies, by Income Quintile . . . . .	45
3.4	Basic Services Subsidies by Expenditure Quintile . . . . .	50
3.5	Rigidity of the Central Government Budget, 2001–04 . . . . .	53
3.6	Ecuador: Personnel Involved in Defense and Security. . . . .	55
3.7	Estimated Tax Expenditures of the Internal VAT Exemptions . . . . .	58
3.8	Progress by Ecuador in Meeting the Millennium Development Goals . . . . .	60
3.9	Estimated Fiscal Cost of Attaining Key MDGs and Social Targets . . . . .	63
3.10	Potential Sources of Fiscal Space . . . . .	68
4.1	Basic Elements of Public Expenditure Management: The “Three-level Analysis” . . . . .	72
4.2	Allocation of Public Spending by Tiers . . . . .	73
4.3	Review of Ecuador’s Public Expenditure Management and Benchmarks . . . . .	75
4.4	Ranking of Ecuador’s PEM in Relation to Peru, Bolivia, and HIPC Indicators . . . . .	77
4.5	Sources of Government Financing . . . . .	78
4.6	Budgetary Assumptions and Actuals . . . . .	79
4.7	Level of Budget Execution of Sector Expenditures. . . . .	81
4.8	Changes in the Budget Share between Executed and Approved . . . . .	82
4.9	Forms of Local Participation within Selected Priority Social Programs . . . . .	85
4.10	Budget of Priority Social Programs Grouped by Social Sector . . . . .	86
4.11	Budget Approved and Executed for Priority Social Programs . . . . .	87
4.12	Budget Execution and Tracking Survey of Transactional Delays within PSPs . . . . .	89
4.13	Positive Qualifications per Country. . . . .	95

## LIST OF FIGURES

ES.1	Oil Prices, Growth, and the Fiscal Deficit. . . . .	xxii
ES.2	Debt Sustainability under the Fiscal Rule. . . . .	xxiv
ES.3	Incidence of Social Expenditure and Energy Subsidies, 1999 . . . . .	xxvii
1.1	Total Public Sector Net Work . . . . .	7
2.1	Non-Financial Public Sector Balances . . . . .	12
2.2	Tax and Non-Tax Revenue of the Central Government and Important Tax Reform Efforts 1964–2004 . . . . .	14
2.3	Total and Primary Expenditures . . . . .	18
2.4	Trends in NFPS and Central Government Expenditures. . . . .	18
2.5	Public Expenditure by Selected Functions . . . . .	19
2.6	Composition of Wages by Selected Sectors . . . . .	21
2.7	Institutional Composition of Public Fixed Investment . . . . .	25

2.8	“Optimal” and Actual Stabilization Accumulation Scenarios . . . . .	27
2.9	Base Case for Debt Sustainability . . . . .	32
3.1	Incidence of Social Expenditure and Energy Subsidies . . . . .	44
3.2	Telephone Penetration by Household Income Quintile . . . . .	50
3.3	Rigid Compared to Flexible Public Expenditure. . . . .	54
3.4	Military Expenditure, 1998–2001 . . . . .	56
3.5	Decomposition of Budget and Off-Budget Financing Sources. . . . .	57
3.6	Chile: <i>Fondo Concurvable</i> . . . . .	65
4.1	Changes in Share of NFPS Expenditures, by Government Tier . . . . .	72
4.2	Emergency Decrees . . . . .	80
4.3	Stock of Arrears . . . . .	83
4.4	Budget Execution of Social Programs . . . . .	88
4.5	Seasonal Patterns in Budget for Social Programs . . . . .	90
4.6	Planned Compared to Executed Transfers of the 15-Percent Law, 1997–2003 . . . . .	91
4.7	Transfers and Payments of the 15-Percent Law to Municipalities. . . . .	93
4.8	Transfers of the 15-Percent Law and the New Subnational Budget Cycle . . . . .	93
4.9	LAC Index of Budgetary Transparency . . . . .	94
4.10	Revenue Base for the 15-Percent Law with/without Oil Revenue . . . . .	102

## LIST OF BOXES

1.1	The Costs and Benefits of Dollarization . . . . .	5
1.2	Ecuador’s Political Economy . . . . .	9
2.1	The Civil Service and the Wage Unification Law: A Step in the Right Direction . . . . .	22
2.2	Ecuador’s Oil Funds . . . . .	26
2.3	The Base Case Scenario . . . . .	32
3.1	Teacher Absenteeism in Primary Schools . . . . .	48
3.2	Household Expenditures on Water: The Case of Machala, El Oro . . . . .	51
3.3	Main Conclusions of the World Bank Ecuador Poverty Assessment . . . . .	61
3.4	The Chilean Competitive ( <i>Concurvable</i> ) Fund for Public Programs . . . . .	66
4.1	The Six Stages of a Comprehensive Multiyear Budgeting Framework . . . . .	98
4.2	Main Recommendations of the IMF-ROSC . . . . .	99
4.3	Ecuador—Institutionalizing a Virtual Poverty Fund: A Look at Best-Practice in Uganda . . . . .	101

## LIST OF ANNEX TABLES

A.1	Structural Fiscal Balance . . . . .	109
C.1	Budget Execution at BDH, by Financing Source . . . . .	117
C.2	Budget Execution at PAI, by Financing Source . . . . .	118

C.3	Budget Execution at LMG, by Financing Source . . . . .	121
C.4	Budget Execution at PRADEC, by Financing Source . . . . .	123
C.5	Budget Execution at PAE, by Financing Source . . . . .	123
D.1	Current and Capital Spending of Municipalities and Provincial Councils . . . . .	130
D.2	Priorities of Subnational Investment Spending . . . . .	131
D.3	Capital Spending of Municipalities and Provincial Councils in the Health and Education Sectors . . . . .	133
D.4	Administration of Schools, Teachers, and Students in The Education Sector, School Year 2000–01 . . . . .	134
D.5	Public Spending in Health Sector . . . . .	134
E.1	Subsidy Distribution by Consumption Deciles . . . . .	138
E.2	Distribution of the Cooking-Gas Subsidy by Ethnic Group . . . . .	138
E.3	Effect of Various Reform Scenarios for the Cooking-Gas Subsidy . . . . .	139

## LIST OF ANNEX FIGURES

A.1	Actual and Potential GDP . . . . .	107
A.2	Primary Balance . . . . .	108
B.1	Flow of Budgetary Funds . . . . .	112
C.1	Organization of the BDH Operating in 14 Provinces . . . . .	116
C.2	Organization of PAI Operating Nationwide . . . . .	119
C.3	Organization of LMG Operating in 40 Municipios . . . . .	120
C.4	Organization of PRADEC Operating in 443 Juntas Parroquiales . . . . .	122
C.5	Organization of PAE Operating in the Coast and Sierra . . . . .	124
D.1	Intergovernmental Transfers, 1996–2003 . . . . .	128
D.2	Sources of Revenue for Transfers to Subnational Governments . . . . .	129
D.3	Own Revenue and Expenditures per Level of Government and Vertical Fiscal Imbalances, 1997 and 2002 . . . . .	132
E.1	Distribution of the Gas Subsidy Retargeted with SelBen . . . . .	140