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Report No: PGD84

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF US$500 MILLION

TO THE

REPUBLIC OF ECUADOR

FOR THE

First Inclusive and Sustainable Growth DEVELOPMENT POLICY LOAN

May 13, 2019

Macroeconomics, Trade and Investment Global Practice
Latin America and Caribbean Region

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Republic of Ecuador

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of February 1, 2019)
The US Dollar is the currency in Ecuador

ABBREVIATIONS AND ACRONYMS

ARCH	Regulatory Agency for Hydrocarbon *(Agencia de Regulación y Control Hidrocarburifero)*
ARCONEL	Regulatory Agency for Electricity (*Agencia de Regulación y Control de Electricidad)*
ASA	Advisory Services and Analytics
CAF	Development Bank of Latin America
CONAFIPS	*Corporación Nacional de Finanzas Populares y Solidarias*
CIT	Corporate Income Taxes
CPF	Country Partnership Framework
DPF	Development Policy Financing
EFF	Extended Fund Facility
ESMAP	Energy Sector Management Assistance Project
FDI	Foreign Direct Investment
FLAR	American Reserve Fund
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
ICSID	International Center for Settlement of Investment Disputes
IDB	Inter-American Development Bank
IFIs	International Financial Institutions
IMF	International Monetary Fund
ISD	Capitla Ouflows Tax (*Impuesto de la Salida de Divisas)*
LDP	Letter of Development Policy
MEF	Ministry of Economy and Finance
MSMEs	Micro, Small, and Medium Enterprises
MTFF	Medium-Term Fiscal Framework
NFPS	Non-financial Public Sector
OPEC	Organization of Petroleum Exporting Countries
OECD	Organization for Economic Cooperation and Development
PDO	Project Development Objective
PEFA	Public Expenditure and Accountability Assessment
PIT	Personal Income Taxes
PFR	Public Finance Review
PFM	Public Financial Management
PPP	Public-private Partnership
SCD	Systematic Country Diagnostic
SENPLADES	Planning Secretary (*Secretaria Nacional de Planificación y Desarrollo)*
SERCOP	Public Procurement Service *(Servicio Nacional de Contratación Pública)*
SOE	State-owned Enterprise
TA	Technical Assistance
VAT	Value-added Taxes
WBG	World Bank Group
WTO	World Trade Organization

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REPUBLIC OF ECUADOR

ECUADOR INCLUSIVE AND SUSTAINABLE GROWTH DPF

TABLE OF CONTENTS

SUMMARY OF PROPOSED FINANCING AND PROGRAM 3

1. INTRODUCTION AND COUNTRY CONTEXT 5

2. MACROECONOMIC POLICY FRAMEWORK 8

2.1. RECENT ECONOMIC DEVELOPMENTS 8

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY 13

2.3. IMF RELATIONS 15

3. GOVERNMENT PROGRAM 16

4. PROPOSED OPERATION 17

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION 17

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS 18

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY 36

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS 36

5. OTHER DESIGN AND APPRAISAL ISSUES 37

5.1. POVERTY AND SOCIAL IMPACT 37

5.2. ENVIRONMENTAL ASPECTS 39

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS 40

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY 43

6. SUMMARY OF RISKS AND MITIGATION 44

ANNEX 1: POLICY AND RESULTS MATRIX 47

ANNEX 2: FUND RELATIONS ANNEX 52

ANNEX 3: LETTER OF DEVELOPMENT POLICY 55

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE 64

ANNEX 5: COORDINATION WITH MULTILATERALS 79

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The team appreciates the excellent collaboration with the Government of Ecuador and acknowledges the coordination efforts of the Ministry of Economy and Finance and the valuable support of the Advisor to the Executive Director Advisor.

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P169822	Yes	1st in a series of 2

Proposed Development Objective(s)

This DPF series support reforms to: i) promote a more efficient mobilization and allocation of government resources; ii) reduce barriers for private sector development; iii) protect and include vulnerable segments of the population.

Organizations

Borrower: REPUBLIC OF ECUADOR

Implementing Agency: MINISTRY OF ECONOMY AND FINANCE

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**500.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	500.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

High

Results

Indicator Name	Baseline	Target
Results Indicator #1: Difference between approved and actual budget.	16.3% (2017)	10% (2021)
Results Indicator #2: Spending in goods and services and personnel as a share of GDP.	14.7% (2017)	13.8% (2021)
Results Indicator #3: Energy subsidies as a share of oil revenues.	38.3% (2017)	37.1% (2021)
Results Indicator #4: Tax revenues[1] as a share of GDP.	13.5% (2017)	14.9% (2021)
Results Indicator #5: The number of new government contracts for amounts higher than US$50 million, including PPP contracts in the tender process, that allow for international arbitration.	0 (2017)	At least 3 (2021)
Results Indicator #6: i) Number of new commercial companies registered, and ii) average days to import[2].	i) 8210 (2017) ii) 4.9 (2017)	i) 10800 (2021) i) 4.3 (2021)
Results Indicator #7: i) Co-movement[3] between interest rate ceilings and nominal interest rates charged by banks for ordinary consumption and ii) participation of second tier financing in the new lending operations of public banks[4].	i) 0 (2017) ii) 0 (2017)	i) >0.2 (2021) i) 17% (2021)
Results Indicator #8: Share of households in the bottom 40 percent of the consumption distribution receiving compensation mechanisms for the subsidy reforms.	0 (2017)	80% (2021)
Results Indicator #9: Approved regulatory framework of the labor reform.	No	Yes
Results Indicator #10: The number of debit card transactions associated to consumption.	33 million (2017)	57 million (2021)

[1] Excluding social security contributions
[2] Including time for nationalization and customs procedures.
[3] Co-movements is proxied by the ratio between standard deviation of monthly interest rate ceiling and the standard deviation of the effective interest rate measured with monthly data over an 18-month period.
[4] Measured as the average new lending of BanEcuador and National Financial Corporation (CFN) during the reference year

IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF ECUADOR

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed programmatic Development Policy Financing (DPF) series supports Ecuador's efforts to restore fiscal sustainability and build the foundations for inclusive and sustainable economic growth.** The two operations in the DPF series will support the Government's medium-term reform program to increase the efficiency of public spending and revenue mobilization, contributing to an orderly fiscal consolidation process. The series also supports structural reforms to remove barriers to private sector development, enabling the private sector to participate in the growth process. Finally, the series supports efforts to ensure that vulnerable segments of the population are protected from the impacts of the first two sets of reforms.

2. **This first operation in the series, in the amount of US$500 million, is part of a joint effort by the international community to support Ecuador's macro stabilization and inclusive growth program and help the country meet its financing needs**. These efforts include a three-year Extended Fund Facility (EFF) by the International Monetary Fund (IMF), and financing packages from the Development Bank of Latin America (CAF), the Inter-American Development Bank (IDB), and the Latin American Reserve Fund (FLAR). The DPF program has been closely coordinated with international financial institutions (IFIs), especially the IMF. As a result, there is a high degree of complementarity across the different programs. While the IMF's EFF focuses primarily on improving the fiscal framework and strengthening the credibility of the dollarization regime, the World Bank's DPF is supporting efficiency gains in the allocation of government resources, structural reforms to foster private sector developments, and improvements in social protection and inclusion.

3. **This DPF series plays a central role in the World Bank Group's (WBG's) enhanced engagement with the Government of Ecuador (the Government) in the context of a new County Partnership Framework (CPF)**. The WBG's FY19-FY23 CPF is being presented together with this operation and constitutes the first full-fledged World Bank Strategy for the Republic of Ecuador since 2007. The DPF series underpins two of the three results areas covered by the CPF. Pillars 1 and 2 of the proposed DPF series support CPF objectives under results area i) Supporting Fundamentals for Inclusive Growth, while the DPF series' Pillar 3 supports CPF objectives under results area ii) Building Human Capital and Protecting the Poor.

4. **Ecuador achieved high growth and significant social gains during the last oil price boom, but it accumulated macroeconomic vulnerabilities.** Between 2001 and 2014, GDP growth averaged 4.5 percent, well above the regional average of 3.3 percent. During this period, real GDP per capita increased by 43 percent. Poverty fell from 37 to 22 percent of the population between 2007 and 2014, lifting 1.4 million people out of poverty. Social gains were supported by higher labor incomes, redistribution, and better access to services. These results were accompanied by a large expansion of the public sector which became the main driver of growth after 2007. Public spending soared from 20 percent of GDP in 2004 to 44 percent of GDP by 2014, driven by expansions in both investment and current spending. Public sector growth led to an expansion in service delivery, but at the expense of efficiency.[5] The expansion was

[5] Ecuador Systematic Country Diagnostic (SCD) 2018.

partially financed by higher oil revenues.[6] However, over this period, Ecuador also dismantled its sovereign oil funds, incurred in a selective debt default, and increased its public debt from 17 percent of GDP in 2012 to 27 percent in 2014. This expansionary fiscal stance accentuated the symptoms of Dutch disease, which combined with a non-conducive business environment, dampened private investment.

5. **The country now faces the challenge of adjusting its economy to low and volatile oil prices and tightened external financing.** When oil prices dropped in 2014, with a dollarized economy and limited fiscal buffers, Ecuador could neither depreciate its currency nor undertake countercyclical fiscal policies. As revenues plummeted, the Government cut spending, mainly public investment, accentuating an economic deceleration in 2015-16. Despite these efforts, fiscal deficits widened, arrears accumulated, and the public debt increased swiftly, reaching 46 percent of GDP in 2018 (from 27 percent in 2014). External imbalances led to a sharp decline in international reserves since 2015, with temporary relief when Ecuador managed to mobilize costly external financing. Poverty reduction lost momentum during this time, with the poverty rate increasing slightly between 2014 and 2018. Labor market conditions deteriorated, and informality increased, while fiscal pressures led to a reduction in coverage of the country's main conditional cash transfer (CCT) program. Adapting to this challenging context requires addressing macro-fiscal imbalances and shifting from a state-led economic model to a balanced, productivity-driven one. At the same time, the adjustment process must be managed carefully to safeguard the social achievements of the last two decades.

6. **The proposed DPF series supports the Government's efforts to adapt to the challenging external environment and to transition to a sustainable and inclusive growth model.** The Government's Program recognizes the difficulties of executing the ambitious reform agenda and proposes a series of incremental steps that will help it achieve its medium-term goals. The first operation in the DPF series (DPF 1) supports solid initial steps in the implementation of this agenda, while the second operation (DPF 2) will deepen these efforts. The series is composed of three pillars. Reforms under Pillar 1 support improved and fiscally aligned budget processes, sound human resources management, increased transparency and efficiency in public procurement, lower and better targeted energy subsidies, and a more effective tax structure that raises more revenues through less distortive taxes. Reforms under Pillar 2 aim to reduce barriers to private sector development, supporting a more balanced growth process. They include regulations to foster large private investment and public-private partnerships (PPPs), lower the costs for opening firms and importing goods and services, reduce financial sector distortions and improve complementarity between public and private financing institutions. Finally, reforms under Pillar 3 aim to protect and include vulnerable segments of the population. These include efforts to improve the effectiveness of social programs, design well-targeted compensations against the impacts of fiscal reforms, promote formality by tailoring labor markets to the needs of vulnerable segments of the population, and promote financial inclusion.

7. **The Program supported by this DPF series is also aligned with the country's climate mitigation and adaptation objectives**. Pillar 1 supports the Government's efforts to rationalize energy subsidies and improve sector efficiency, reducing the gap between final prices, production costs, and market values for fuels and electricity. These reforms are part of a broader reform agenda to change the country's energy profile. Pillar 3 contributes to the households' adaptability to climate change and to the energy subsidy reforms. Ecuador's geological and hydro-meteorological dynamics make it susceptible to several

[6] In 2011, the government renegotiated oil contracts with the private sector, resulting in a larger share of oil revenues flowing to the public sector

types of natural and geological occurrences including earthquakes, volcanic eruptions, tropical storms, floods and landslides. Climate extremes are already the most common type of disasters in Ecuador, and their frequency is expected to intensify with climate changes, adversely affecting the population and the economy. Pillar 3 also supports a reform to the country's social registry to expand its objectives, scope, and users. The information provided by the updated registry will be fundamental for the Government to provide quick and targeted emergency responses, and to support vulnerable segments of the population in a post-disaster scenario.

8. **The DPF series build on strong policy dialogue and close collaboration with the Government, as well as on the findings of analytical work, including the recent Systematic County Diagnostic (SCD).** Since 2017, the World Bank has engaged with the Government in a wide range of analytical and advisory work in the areas of public finance, energy reform, competitiveness, financial sector, and social protection. Examples include: (i) the programmatic Public Finance Review (PFR), which covers areas such as taxes, public procurement, the wage bill, and public financial management (PFM), among others; (ii) the Energy Subsidy Reform Assessment, funded by Energy Sector Management Assistance Program (ESMAP), which supports the communication, fiscal, social, and sectorial aspects of these reforms; (iii) the Trade, Investment, and Competitiveness report, which identifies key barriers to private investment, and (iv) the Financial Stability and Inclusion report. This DPF series fits within the short-term policy priorities identified in the 2018 SCD. Finally, the upcoming flagship on Jobs will inform triggers for DPF 2. These analytical underpinnings have helped identify measures to tackle the critical challenges of fostering sustainable and inclusive growth in Ecuador. They have also provided a window for technical assistance focused on the design and implementation of the measures supported in this DPF series in close collaboration with the Government.

9. **The proposed DPF series is being prepared under a complex political context.** Ecuador is going through a period of political and economic transformation. President Lenin Moreno took office on May 24, 2017, following the ten-year term of ex-President Rafael Correa. Despite serving as Vice President for six years under the previous administration, President Moreno has followed a different policy direction than previous administration by, among other things, creating space for the private sector to play a greater role in development and enhancing transparency and accountability of the state. President Moreno does not count upon a majority in the National Assembly and thus needs to mobilize support from among the opposition to secure approval of individual reform initiatives. The challenging economic situation and initial adjustment efforts have also impacted the President's popularity, which has been declining in recent months.

10. **The risks associated with the proposed DPF 1 are high.** While there is a strong commitment by the Government to its reform agenda, there are significant downside risks that could delay or complicate the implementation of structural reforms. Macroeconomic risks are high as stagnant oil prices, and/or a tightening of global financial conditions, could make it harder to meet financing needs. Domestic risks such as a natural disaster could further aggravate the macro situation. Limited implementation capacity, combined with Ecuador's complex political context, could also lead to delays in the approval or implementation of reforms. Full adherence to the fiscal and monetary targets of the IMF program will contribute to a stable macroeconomic framework. Technical assistance and World Bank support to the design of a communication strategy in support of key reforms would also help mitigate these risks.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

11. **After sustaining more than a decade of high growth on the back of high oil prices, Ecuador has seen a marked slowdown in GDP growth since oil prices plummeted in mid-2014**. The remarkable episode of stable growth experienced between 2001-2014 (where GDP growth averaged 4.5 percent) marked a break with two decades of booms and busts. It was initially driven by stabilization reforms and the decision to adopt the US dollar as the national currency in the early 2000s but was then fueled by high oil prices. However, as oil prices plunged from US$106 per barrel in July 2014 to US$30 per barrel in January 2016, GDP stagnated in 2015 and contracted 1.2 percent in 2016. Growth resumed in 2017, reaching 2.4 percent on the back of external financing, recovering oil prices and domestic credit, but lost momentum again declining to 1.4 percent in 2018. This deceleration was a result of the ongoing fiscal consolidation, declining oil production, and declining private demand.

12. **An integral part of the economic boom can be explained by the rising role of the public sector. (Box 1).** Public expenditure increased from 21 percent of GDP in 2006 to 44 percent in 2014. Current spending expanded by 11.5 percentage points of GDP between 2006 and 2014, driven by wages and salaries, social security contributions, and, most notably, other expenditures including items such as oil imports, fuel subsidies, and service fees to private oil operators.[7] Government purchases of goods and services also expanded in the latter part of this period. Capital spending expanded by about 9.5 percentage points of GDP in the same period, as a sizable share of the oil windfall was directed to investment projects in infrastructure and energy, and to social programs[8]. These items fueled domestic demand, further accelerating growth. The public sector expansion was financed by oil revenues, dissaving, and external funding. During this time, the Government dismantled its sovereign oil fund[9] and incurred in a selective debt default despite benign external conditions. Other measures, including changes to oil contracts, further eroded Ecuador's investment climate and stymied private investment. Regulatory changes, such as changes to the labor code, created rigidities in the labor supply and eroded competitiveness in the private sector.

13. **Public-sector dynamics also explain the sharp slowdown since 2014.** Expansionary policies and regulatory changes during the boom period hampered the country's ability to respond to the negative external shock that hit in 2014. The selective default and the lack of macroeconomic buffers increased the country's risk ratings, limiting access to the external funding needed to smooth the fiscal and external adjustments facing Ecuador's dollarized economy. With limited options, the Government resorted to large cuts in investment spending and to costly methods of financing, which had a strong negative effect on activity. With its competitiveness eroded by the real exchange rate appreciation and labor market and price rigidities, Ecuador's stagnant and underinvested private sector was unable to offset the decline in public sector demand.

[7] Interest payments decreased due to a selective default of international bonds worth US$3.2 billion. In December 2008 the Government stopped payments of Global 2012 and 2030 bonds even though they had the resources to do so. In 2009 it bought back US$2.9 billion worth of defaulted bonds at US$900 million, hence reducing interest payments by about US$300 per year.
[8] Many social programs are classified as investment spending in Ecuador.
[9] The fund was dismantled in 2008 and its resources absorbed by the annual budget.

Box 1. The impacts of Ecuador's public sector-driven growth model on private sector activity

The oil boom of the early 2000s allowed the Government to embark on an ambitious agenda to improve roads, housing, schools, and hydroelectric generation. Ecuador's public investment was the highest among its structural peers, averaging 11 percent of GDP between 2007 and 2014. Many of these investments helped the country improve social outcomes and its infrastructure—access to education and health services increased and key transport infrastructure was built. Moreover, as the public sector injected resources from the oil boom into the economy, aggregate economic activity and household income increased.

Notwithstanding its benefits, the growth model of the boom years was unsustainable and constrained private sector development. Changes to the labor code to expand and improve benefits to workers also reduced flexibility to adjust to shocks. These changes significantly increased the minimum wage and costs associated with separation benefits for employees (which are the highest among peers). The Government also promoted an import substitution strategy whereby tariffs on imports were increased to protect domestic production. In addition, the Government introduced capital outflow taxes and tariff surcharges to limit balance of payments imbalances, especially in times of stress such as the global financial crisis and the oil price drop. While many of these policies tackled priorities in the Government's social and macro agenda at the time, they also introduced costs and rigidities to the private sector.

In addition, the public sector-driven growth model observed between 2007 and 2017 had a negative impact on the private sector through factor prices. The ambitious agenda to expand the footprint of the Government translated into an expansion of public employment. Indeed, between 2009 and 2016 public employment growth outpaced private employment growth by 15 percentage points. Moreover, employment growth was above average in non-tradeable activities like construction and public services, while it was below average in manufacturing and agriculture. At the same time, wages for public employees increased, putting upward pressures on private sector wages[10].

As a result, the competitiveness of Ecuador's tradeable sector was weakened during the oil price boom. The high growth of the 2007-2017 period was driven mainly by factor accumulation; total factor productivity stagnated. Labor productivity also grew at a slower rate than wages. The high costs of labor and non-tradeable services combined with weak productivity growth resulted in a noticeable erosion in Ecuador's competitiveness. The country's real exchange rate, a measure of competitiveness, appreciated more than that of other countries that benefitted from the commodity boom, and remained appreciated after oil prices dropped.

14. **Amid recent improvements in the business climate, rising private investment has partially cushioned the effect of public investment cuts over the last two years.** Although capital expenditure by the non-financial public sector (NFPS) dropped by about eight percentage points of GDP between 2014 and 2018 (from 15 to below 7 percent), the overall gross capital formation remained at around 26 percent of the GDP over the same period. This is because policy reforms have helped improve the investment climate since 2017, resulting in an increased of private investment over the same period. The Government also repealed the import surcharges introduced in 2015 and dropped the tax on real estate capital gains

[10] Ecuador SCD 2018.

introduced in 2016. It signed a free trade agreement with the European Union at the end of 2016 and the European Free Trade Association in 2018 and is presently negotiating trade and investment agreements with the United States, the Pacific Alliance (Chile, Peru, Colombia, and Mexico), Canada, and Japan among others. In the oil sector, the country's oil-producing state-owned enterprise (SOE), PetroAmazonas, signed oil service contracts that replaced fixed payments for variable fees based on international oil prices, and the Government introduced a law to reinstate production sharing agreements. Moreover, in August 2018, the Government passed a Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability which introduced a first round of reforms geared toward improving fiscal sustainability and promoting private investment.

Table 1. Key Macroeconomic Indicators[11]

	2014	2015	2016	2017	2018	2019f	2020f	2021f	2022f	2023f
Real sector, annual percentage change, unless otherwise indicated										
Nominal GDP (US$ billion)	101.7	99.3	99.9	104.3	108.4	109.5	111.7	114.5	118.5	122.8
GDP growth	3.8	0.1	-1.2	2.4	1.4	0.0	0.4	0.8	2.1	2.1
Private Consumption (Contribution)	1.7	-0.1	-1.5	2.3	1.6	0.2	0.4	0.8	1.0	1.0
Government Consumption (Contribution)	1.0	0.3	0.0	0.5	0.4	-1.0	-0.3	-0.1	0.3	0.3
Gross fixed capital formation (Contribution)	0.6	-1.7	-2.2	1.2	0.5	0.4	0.1	0.1	0.7	0.8
Changes in inventories (Contribution)	0.3	-0.8	-0.6	1.4	0.2	0.0	0.0	0.0	0.0	0.0
Net exports (Contribution)	0.2	2.3	3.1	-3.0	-1.4	0.4	0.2	0.0	0.0	0.0
GDP deflator	3.0	-2.5	1.9	1.9	2.5	1.1	1.5	1.7	1.4	1.5
Consumer price index (p.a.)	3.6	4.0	1.7	0.4	-0.2	0.6	1.2	1.4	1.0	1.0
Fiscal accounts, percent of GDP										
Public revenues	38.4	33.6	30.3	32.0	35.9	35.3	36.9	36.3	36.1	35.7
Public expenditure	43.6	39.5	37.6	36.5	37.1	35.7	34.7	33.6	33.5	33.3
o.w. Capital expenditure	15.1	11.8	11.0	9.3	6.6	6.6	6.2	5.7	5.6	5.6
NFPS balance	-5.2	-6.0	-7.3	-4.5	-1.2	-0.4	2.2	2.7	2.6	2.5
NFPS debt	26.7	33.4	42.3	45.0	46.0	47.1	45.0	43.7	39.7	35.8
Balance of payments, percent of GDP, unless otherwise indicated										
Current account balance	-0.7	-2.2	1.3	-0.5	-1.3	-0.9	-0.5	-0.2	0.2	0.7
Exports	26.1	19.2	17.4	18.8	20.4	21.0	21.3	21.5	21.6	21.7
o.w. oil export	12.8	6.4	5.1	5.9	7.2	6.9	6.8	6.6	6.4	6.2
Import	26.2	20.8	15.9	18.5	20.7	20.8	20.8	20.8	20.6	20.4
Foreign direct investment	0.8	1.3	0.8	0.6	1.3	1.6	1.7	1.8	1.9	1.9
International reserves (US$ billion)	4.0	2.5	4.3	2.5	2.7	5.2	5.8	7.5	7.2	8.0
Months of imports	1.6	1.3	2.7	1.3	1.3	2.4	2.6	3.3	3.1	3.3
Percentage of GDP	3.9	2.5	4.3	2.4	2.5	4.7	5.2	6.5	6.1	6.5

Source: Central Bank of Ecuador, Ministry of Economics and Finance, and staff's estimates. f = forecast

15. **Despite initial efforts to curb public spending, the fiscal deficit widened, and the public debt soared**. Since 2014, capital spending of the NFPS has declined by 9 percentage points of GDP, reaching 6.6 percent in 2018, approaching the level of regional peers like Colombia and Peru. However, the rigid nature of current expenditure (for example, wage payments to public servants) limited the Government's ability to adjust public expenditure to the new reality. The Government tried to prevent a sharper expenditure consolidation by tapping into diverse sources of financing. These sources included standard international bond issuances and budget support from bilateral and multilateral creditors, and non-standard financing instruments such as advanced oil sales, Central Bank financing, and arrears. Despite these and other temporary revenue-raising measures, the fiscal deficit remained above 4.5 percent between 2014-2017[12] and NFPS debt increased from 27 percent of GDP in 2014 to 45 percent in 2017.[13]

[11] Fiscal projections are consistent with the adjustment measures proposed by the IMF Program.
[12] From less than 1 percent of GDP on average in 2010-2013.
[13] NFPS debt estimated by the WBG staff as official debt reports refer to the aggregate public debt. The NFPS debt is composed by the external debt and the domestic debt held by the private sector, the Central Bank and other public financial institutions. The external debt includes the official external debt, advanced oil sales, and a financial operation with Schlumberger. The domestic debt includes the treasury certificates (CETES), letters of credit related to fuel imports, the arrears of PetroAmazonas and the Hydrocarbons Secretary with the private oil companies, and other payables.

Many of these policies hampered economic activity. For example, amid a deterioration of the Central Bank's balance sheet due to lending to the public sector and arrears with the private sector, the country's liquidity was reduced, and credit and domestic demand shrunk.

16. **The new economic team that took office in the Ministry of Economy and Finance (MEF) in May 2018 has pursued an orderly and gradual fiscal adjustment but has faced challenges.** The MEF team established the goal of gradually reducing the overall fiscal deficit over a four-year period and of reducing debt to the 40 percent debt ceiling over the same period as part of the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability.[14] The adjustment focuses on reducing current expenditure to levels that are consistent with non-oil revenues. The initial roll-out of the consolidation plan suffered some setbacks stemming from rigidities in current expenditures, higher interest payments, and weaknesses in the budgetary process. As a result, most of the adjustment for the year relied again on capital spending cuts.

Table 2. Key Fiscal Indicators[15]

% of GDP	2014	2015	2016	2017	2018	2019f	2020f	2021f	2022f	2023f
Overall balance (NFPS)	-5.2	-6.0	-7.3	-4.5	-1.2	-0.4	2.2	2.7	2.6	2.5
Primary balance	-4.2	-4.6	-5.8	-2.3	1.3	2.1	4.7	5.2	5.0	4.7
Revenue	38.4	33.6	30.3	32.0	35.9	35.3	36.9	36.3	36.1	35.7
Oil revenues	10.7	6.5	5.4	5.6	8.0	7.7	7.6	7.4	7.2	7.0
Tax revenues	18.9	20.8	18.8	18.7	19.3	18.2	19.7	20.1	20.1	20.1
Taxes on goods and services	7.1	7.2	6.2	6.6	6.8	6.2	7.4	7.9	7.9	7.8
Taxes on international trade	1.3	2.0	1.6	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Income tax	4.1	4.8	3.6	3.6	4.4	3.9	4.2	4.2	4.2	4.2
Social security	4.6	5.1	4.7	5.2	5.1	5.1	5.2	5.2	5.3	5.3
Other taxes	1.7	1.6	2.6	1.9	1.6	1.6	1.6	1.4	1.4	1.4
Operative balance of SOEs	4.1	1.1	0.6	2.0	2.4	2.3	2.4	2.3	2.3	2.2
Other	4.7	5.1	5.5	5.7	6.2	7.1	7.2	6.5	6.5	6.5
Expenditure	43.6	39.5	37.6	36.5	37.1	35.7	34.7	33.6	33.5	33.3
Expense	28.5	27.7	26.6	27.2	30.5	29.2	28.5	27.9	27.9	27.7
Compensation of employees	9.3	10.0	10.0	9.9	9.8	9.3	9.0	8.8	8.8	8.8
Purchases of goods and services	5.2	5.1	4.7	4.8	5.7	5.2	5.2	5.0	5.1	5.0
Interest	1.0	1.4	1.6	2.1	2.5	2.5	2.5	2.5	2.4	2.2
Domestic	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Foreign	0.8	1.1	1.3	1.8	2.1	2.2	2.2	2.2	2.2	2.0
Social security	3.6	4.3	4.7	4.8	5.0	5.2	5.3	5.5	5.6	5.7
Other expense	9.3	6.9	5.7	5.5	7.5	6.9	6.6	6.1	6.0	6.0
Capital expenditure	15.1	11.8	11.0	9.3	6.6	6.6	6.2	5.7	5.6	5.6
NFPS financing	5.2	6.0	7.3	4.5	1.2	0.4	-2.2	-2.7	-2.6	-2.5
External, net	4.3	3.1	5.2	4.9	2.7	2.4	-0.4	0.3	-2.0	-1.4
Domestic, net	0.9	2.9	2.1	-0.5	-1.5	-2.0	-1.8	-3.0	-0.6	-1.1
NFPS debt	26.7	33.4	42.3	45.0	46.0	47.1	45.0	43.7	39.7	35.8
External debt	18.7	22.3	28.1	32.0	34.0	36.1	35.0	34.5	31.3	28.9
Domestic debt	8.0	11.1	14.1	13.0	12.0	11.0	9.9	9.3	8.3	7.0
Memo item:										
Central government balance	-6.3	-3.8	-5.6	-5.9	-3.6	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Central Bank of Ecuador, MEF, and staff's estimates. f = forecast

17. **While the NFPS deficit has declined quickly in the past two years, adjustment in the central government deficit has been gradual.** The NFPS deficit fell from a peak of 7.3 percent of GDP in 2016 to an estimate of about 1.2 percent in 2018 on the back of improving oil prices and capital expenditures cuts (Table 2). However, the central government deficit has declined modestly, from 5.6 percent in 2016 to an estimated 3.8 percent in 2018, as higher oil prices benefited mostly public firms outside the central government and increased the cost of subsidies. In fact, higher oil exports allowed state oil enterprises to reach sizable surpluses and reduce their arrears with private agents.

[14] This law also allows the Government to temporarily lifts the debt ceiling to implement the ongoing fiscal consolidation process.
[15] Fiscal projections are consistent with the adjustment measures proposed by the IMF Program.

Table 3. Fiscal Financing Requirements and Sources

% of GDP	2014	2015	2016	2017	2018	2019f	2020f	2021f	2022f	2023f
Gross financing needs (NFPS)	**9.4**	**11.5**	**12.8**	**9.5**	**9.9**	**4.5**	**2.5**	**-0.1**	**2.0**	**1.4**
Fiscal deficit	-5.2	-6.0	-7.3	-4.5	-1.2	-0.4	2.2	2.6	2.5	2.4
External debt amortizations	1.7	2.1	1.8	2.8	2.9	2.6	4.0	1.8	3.9	3.2
Amortizations of other external liabilities	1.8	1.9	1.5	1.2	1.6	0.8	0.4	0.5	0.4	0.4
Assets purchases	0.0	0.1	0.9	0.1	0.6	0.0	0.0	0.0	0.0	0.0
Domestic debt amortization	0.7	1.3	1.2	1.0	3.9	0.7	0.2	0.2	0.2	0.2
Financing sources	**9.4**	**11.5**	**12.8**	**9.5**	**9.9**	**4.5**	**2.5**	**-0.1**	**2.0**	**1.4**
External debt disbursements	6.3	4.9	7.3	8.5	6.6	5.5	3.6	2.2	1.9	1.9
Disbursements of other external liabilities	1.5	2.4	2.2	0.4	1.3	0.4	0.4	0.4	0.4	0.4
Domestic debt disbursements	2.0	0.9	1.2	3.3	3.3	0.5	0.0	0.0	0.0	0.0
Treasury certificates, net	0.2	0.7	3.1	-2.6	-0.5	-0.5	0.0	-0.3	0.0	-0.5
Accumulation of other liabilities, net	0.5	2.6	-0.1	-0.2	0.3	-1.0	-0.3	-0.4	-0.4	-0.3
Depletion of public deposits, net	-0.1	1.0	-1.4	-0.5	-1.0	-0.4	-1.3	-2.0	0.0	0.0
Discrepancy and financing gap	-0.9	-1.1	0.5	0.6	-0.1	0.0	0.0	0.0	0.0	0.0

Source: Central Bank of Ecuador, MEF, and staff's estimates. f = forecast

18. **Limited access to global financial markets forced Ecuador to tap alternative sources of financing in 2018, but financing prospects improved with the signing of an agreement with the IMF early this year.** The central government financing needs for 2018 (approximately 7 percent of GDP) were met mainly from: (i) repurchase agreements with Goldman Sachs and Credit Suisse; (ii) advanced oil sales agreements signed by the previous administration; (iii) resources from FLAR, and (iv) short-term borrowing from SOEs with excess liquidity. The Government placed US$3 billion in bonds in January 2018 but refrained from accessing markets during the rest of the year in view of high costs and volatility. In January 2019, Ecuador issued 10-year bonds for an amount of US$1 billion in the international markets at a rate of 10.75 percent, the highest since it returned to markets in 2015. This rate reflected markets' perception of insufficient efforts to stabilize fiscal accounts, in a context of increasing interest rates and volatile oil prices. However, on March 2019, the IMF's Board of Directors approved an EFF for Ecuador amounting to US$4.2 billion over three years that conveyed credibility to markets. Ecuador's sovereign spreads, which had increased from 600 basis points in mid-September 2018 to around 820 basis points in late December 2018, returned to 600 basis points in March 2019.

19. **The current account deficit and insufficient external financing have constrained the net inflow of dollars, with implication for domestic demand.** As a fully dollarized economy with limited international reserves, Ecuador requires a net dollar inflow to expand its the money supply. However, the current account balance moved from a surplus of 1.3 percent of GDP (US$1.3 billion) in 2016 to a deficit of about 1.3 percent (US$1.4 billion) in 2018 owing to declining oil export volumes, a phase out of import surcharges, and growing domestic demand (Table 4). Real exchange rate appreciation also contributed to this imbalance. With low foreign direct investment, the money supply depends on languishing external financing to the public sector. Against this backdrop, the growth of the monetary base and total money supply dropped between 2016 and 2018, from 28 to approximately 2 percent and from 17 to 6 percent respectively. Similarly, international reserves dropped from US$4.3 billion (4.3 percent of GDP, 3.2 months of imports) in the end of 2016 to US$2.7 billion (2.5 percent of GDP, 1.3 months of imports) in the end of 2018, but recovered partially to US$3.7 billion (3.4 percent of GDP, 2.1 months of imports) in March 2019, after the approval of the IMF EFF.

Table 4. Balance of Payments Financing Requirements and Sources

% of GDP	2014	2015	2016	2017	2018	2019f	2020f	2021f	2022f	2023f
Gross financing needs	**7.1**	**7.5**	**5.0**	**10.9**	**7.1**	**4.7**	**2.9**	**2.5**	**2.5**	**2.4**
Current account	0.7	2.2	-1.3	0.5	1.3	0.9	0.5	0.2	-0.2	-0.7
Public loans amortizations	1.7	1.4	1.8	2.8	2.7	2.5	2.2	1.7	2.3	2.5
Other capital outflows	4.7	3.8	4.5	7.7	3.2	1.3	0.2	0.7	0.4	0.7
Financing sources	**7.1**	**7.5**	**5.0**	**10.9**	**7.1**	**4.7**	**2.9**	**2.5**	**2.5**	**2.4**
Foreign direct investment	0.8	1.3	0.8	0.6	1.3	1.6	1.7	1.8	1.9	1.9
Portfolio investment	1.5	1.5	2.2	6.2	2.4	0.8	-0.9	-0.1	-0.4	0.5
Capital grands	0.1	0.0	-0.8	0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Public loans disbursements	4.3	3.3	4.6	2.3	3.8	4.5	2.7	2.2	0.7	0.7
Changes in reserves	0.4	1.5	-1.8	1.7	-0.2	-2.2	-0.6	-1.4	0.2	-0.6

Source: Central Bank of Ecuador, MEF and Finance, and staff's estimates. f = forecast

20. **The economy experienced a credit upsurge over the past two years, but liquidity declined.** After declining by 2 percent in 2015, credit provided by banks grew 14 percent in 2017 as high external financing allowed the public sector to clear arrears with the private sector and restore liquidity. Credit growth accelerated to 16 percent in 2018 as financial institutions swapped liquidity for loans. The expansion of banks' portfolio increased their returns to equity from 7 percent in 2016 to about 13 percent in 2018, while non-performing loans remained low for regional standards. However, private bank liquidity decreased from a peak of 32 percent of short-term liabilities in 2016 to a historically low of 26 percent in 2018, as credit expansion was not accompanied by dollar inflows into the system. Banks have limited space to further expand unless they begin to borrow overseas, or the money supply expands.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

21. **Growth is expected to remain subdued during the upcoming years, but macroeconomic reforms will set the ground for growth to reignite by 2022-2023.** The economy is likely to stagnate in 2019 as a sizable fiscal consolidation is needed to bring the economy into a sustainable path in a context of lower oil prices and tightening global financial conditions. The decline in public expenditure is expected to impact household income, which could translate into lower private consumption. The contribution of investment to GDP growth will increase, but only slightly. Private investment is expected to accelerate because of an improved regulatory and economic environment, partly offsetting the stagnation of public investment. Economic growth is expected to increase gradually during 2020-2021 as reforms spark enough private investment and non-oil exports to cushion the effects of the fiscal consolidation. However, GDP growth is expected to approach 2 percent in 2022-2023, when the consolidation efforts have been already implemented.

22. **Inflation is expected to remain around 1 percent.** A slowdown in domestic demand and money supply contributed to a decline in average inflation, from 4 percent in 2015 to -0.2 percent in 2018. This trend is expected to reverse amid the gradual improvement in economic activity. One-off effects associated with policy changes such as lower fuel subsidies and higher indirect taxes, could also affect headline inflation. Increased external inflows are expected to enable an expansion of the money supply.

23. **Current account surpluses, improved external financing to the public sector, and a modest growth in foreign direct investment (FDI) are expected to increase international reserves.** Despite declining oil exports and growing interest payments abroad, the current account balance is expected to move from a deficit of 1.3 percent in 2018 to a surplus of 0.1 percent in 2021 on the back of weakened domestic demand and growing non-oil exports. External financing and modest improvements in FDI, encouraged by structural reforms, will further support an expected increase in international reserves from

a low of US$2.7 billion (2.5 percent of GDP) in 2018 to US$8 billion (6.5 percent) in 2023. External financing will allow the Government to clear liabilities with the Central Bank and accumulate deposits.

24. **Consistent with fiscal consolidation plans, the NFPS is expected to reach significant surpluses in the 2019-2023 period on the back of a broad set of reforms.** The NFPS balance is expected to improve from a deficit of about 1.2 percent of GDP in 2018 to a surplus of about 2.7 percent by 2021 (Table 3). Consolidation efforts, including efforts to curb current spending and improve revenue collection supported by this DPF are aligned with the fiscal measures foreseen by the IMF EFF. Plans to rationalize fuel subsidies, terminate temporary contracts, improve procurement processes, reduce the number of public institutions, and optimize SOE operations will also contribute to improving the NFPS balance. Importantly, the baseline scenario assumes that oil production will remain flat between 2019 and 2023 because the Government's efforts to increase production will be offset by the maturing oil fields and Organization of the Petroleum Exporting Countries (OPEC) production quotas.

25. **NFPS debt is expected to fall below 40 percent of GDP by 2023.** Primary surpluses and a gradual recovery in economic growth are expected to lead to a reduction of public debt—from 46 percent of GDP in 2018 to 36 percent in 2023. A rebalancing of public debt, from domestic to external debt, is also expected. External debt is projected to increase from 34 percent of GDP in 2018 to a peak of 36 percent in 2019, while domestic debt is projected to fall from 12 percent of GDP in 2018 to 7 percent in 2023. Increased external debt in the early years of the adjustment could help mitigate the economic impacts by boosting money supply and helping the Government clear its arrears and other liabilities. After 2019, fiscal surpluses and economic growth are expected to lead to a gradual reduction in external public debt, to a low of 29 percent in 2023.

26. **The path of public debt is subject to risks, such as higher interest rates, a weaker than expected fiscal consolidation path, and slower growth.** A permanent increase of the interest rate by 200 basis points from 2020 onward increases the public debt by less than 1.0 percentage point of GDP in 2023 compared to the baseline scenario. A reduction in the primary balance by 1.2 percentage points of GDP in 2020 and 2021 (half of the 10-year historical standard deviation), increases public debt to 39 percent of GDP in 2023, almost three percentage points higher relative to the baseline.[16] The public debt-to-GDP ratio is most sensitive to low GDP growth. A reduction of 2.8 percentage points in growth in 2020 and 2021[17] (the 10-year historical standard deviation) would lead to a sharp increase in public debt. In this scenario, public debt would jump from 46 percent of GDP in 2018 to a peak of 51 percent in 2021, before returning to 43 percent in 2023. If all these stress tests are combined, public debt could increase to a peak 53 percent of GDP in 2020, later declining to 46 percent by 2023, almost ten percentage points above the baseline scenario.

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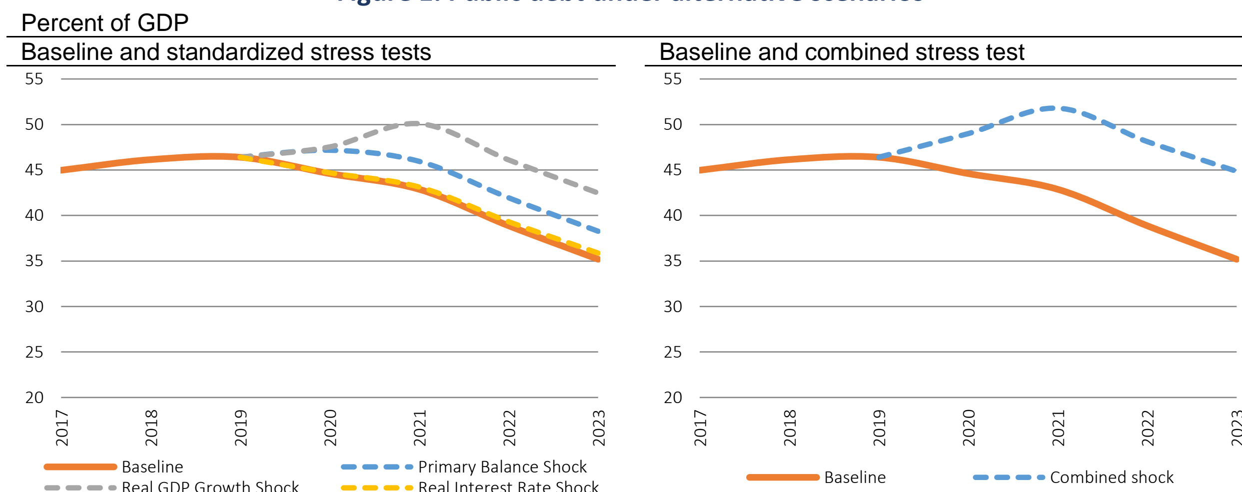
[16] This shock is combined with an increase of the interest rate by 25 basis points per one percent of GDP worsening of fiscal balance.

[17] The scenario is combined with a deterioration of fiscal revenues, higher interest rates (25 basis points per one percent of GDP worsening of fiscal balance) and lower inflation rate (25 basis points per one percentage point decrease in GDP growth).

Figure 1. Public debt under alternative scenarios



Note: The exchange rate shock was excluded because of Ecuador's full dollarization.
Source: Central Bank of Ecuador, MEF and staff estimates

27. **Although Ecuador's public debt to GDP ratio remains below the threshold for emerging markets in all standardized stress tests, high country risk highlights the importance of debt reduction efforts.** Public debt is expected to remain well below the threshold for emerging markets of 70 percent of GDP in all scenarios considered (Figure 1). Nevertheless, Ecuador is still perceived as a high-risk country by financial markets. Past defaults and the absence of strong macroeconomic buffers adversely affect risk perceptions of Ecuadorean debt in international markets. Efforts to reduce public debt towards the legally-mandated debt ceiling of 40 percent of GDP through a credible fiscal adjustment plan could reduce the country's relatively high levels of country risk.

28. **Ecuador's macroeconomic framework, anchored in the IMF-supported program, is adequate for the proposed DPF 1, although downside risks need to be carefully monitored**. The Government is committed to reducing fiscal imbalances and foster private investment to secure macroeconomic stability and set the ground for economic recovery. However, the limited number of macroeconomic buffers make Ecuador vulnerable to downside risks, including prolonged periods of low oil prices, tighter global financial conditions, or an appreciation of the US dollar. On the domestic front, risks stem from a complex political context that could impede or delay the implementation of reforms and from unexpected fiscal pressures associated with natural disasters. It is crucial to foster private investment, private capital inflows, and non-oil exports to prevent the fiscal consolidation and lower dollar inflows from pushing the economy into a recession. A deeper than expected growth slowdown could undermine debt sustainability and erode political support for the reform agenda.

2.3. IMF RELATIONS

29. **On March 11, 2019 the Executive Board of the IMF approved a three-year extended arrangement with Ecuador for a US$4.2 billion under the Extended Fund Facility (EFF).** The EFF, the proposed programmatic DPF series and parallel operations by the IDB and CAF are all part of an effort by these IFIs to mobilize needed financial assistance that the Government estimates at about US$10 billion

over the next three years. Performance criteria for the EFF include a reduction in the non-oil primary deficit of the NFPS (including fuel subsidies), an increase in net international reserves (excluding bank deposits held at the Central Bank), and floors to social assistance spending. Structural benchmarks focus on improving statistics and reporting, the PFM and fiscal frameworks, tax structure, autonomy of the Central Bank, as well as anti-corruption instruments. The IMF and World Bank have coordinated closely on the design of the EFF and the DPF series to ensure consistency and complementarity of policy measures each of them supports. Complementary technical assistance has been offered to the MEF on a number of issues, such as wage bill management, subsidy reform, public financial management, debt management, and financial stability.

3. GOVERNMENT PROGRAM

30. **The Government's strategy for the country's development is enshrined in two plans.** The National Development Plan – *Toda una Vida 2017- 2021* focuses on the country's development goals for the medium- and longer-term, aimed at reducing poverty and increasing shared prosperity. The Government's *Plan de Prosperidad 2018-2021* acknowledges that Ecuador's economy requires strong adjustment through the responsible, transparent and disciplined use of public resources to promote sustainable growth. This plan is focused on short-term measures to enable economic growth and comprises four priorities to help stabilize and reactivate the economy in the short term.

- ***Priority 1: Stabilizing the Economy.*** The Government's plan highlights the need for strong and orderly fiscal adjustment, and that the economic growth needed to address poverty and offer opportunities for the next generations cannot rely solely upon the public sector but must provide the conditions to attract private sector, including foreign, investment;

- ***Priority 2: Protecting the Most Vulnerable.*** The plan acknowledges that the needed fiscal adjustment cannot affect the most vulnerable population. It guarantees that resources for social protection will be increased to reduce the levels of poverty and extreme poverty by increasing the coverage of social protection programs;

- ***Priority 3: Ensuring More Opportunities and Fewer Burdens for Citizens.*** The plan includes a proposal to provide productive credit and regulatory reforms to foster entrepreneurship and reactivate production to create quality jobs without generating fiscal pressures, and

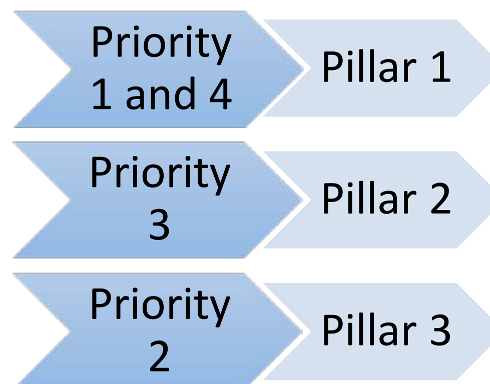
- ***Priority 4: Promoting Transparency and Fighting Corruption.*** The plan also prioritizes establishing the legal framework to combat corruption, including the preparation and submission to the National Assembly of legislation providing incentives to report corruption and protecting whistleblowers. This area also considers more transparency and accountability in the allocation of government resources throughout the annual budget cycle.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

31. **The proposed DPF is the first in a series of two operations supporting reform measures to: (i) promote a more efficient mobilization and allocation of government resources; (ii) reduce barriers to private sector development, and (iii) protect and include vulnerable segments of the population**. Achieving macroeconomic stability and transitioning towards a sustainable and inclusive economic model are primary concerns of the Government. The DPF series complements and reinforces stabilization efforts by supporting measures to increase spending efficiency and revenue mobilization, and tackle distortions and level the playing field for private sector-led growth, which are all important measures to sustain growth under less favorable external conditions. Similarly, strengthening the country's social safety net and promoting financial inclusion will protect the most vulnerable and improve inclusion throughout the adjustment process.

Figure 2: Mapping *Plan Prosperidad* Priorities- DPF Pillars



32. **The DPF series is fully aligned with the Government's developments plans.** The pillars and actions supported by the DPF series reinforce the priorities in the Government's *Plan de Prosperidad 2018-2021*. For example, Pillar 1 of DPF 1 supports the Government's Priority 1 (Stabilizing the Economy) and an orderly fiscal adjustment by promoting efficient spending and revenue mobilization. Pillar 1 also addresses Priority 4 of the Government's plan (Promoting Transparency and Fighting Corruption) by supporting reforms to improve the transparency and accountability of the budget process (Priority 4). By supporting reforms to remove barriers to private sector development, facilitate entrepreneurship and improve financial intermediation, Pillar 2 is closely linked to the Government's Priority 3 (Ensuring More Opportunities and Fewer Burdens for Citizens). Finally, Pillar 3 supports the implementation of the Government's Priority 2 (Protecting the Most Vulnerable), by designing and implementing well-target social protection and compensation programs to protect the vulnerable groups against the impact of fiscal consolidation and providing access to finance by this groups.

33. **The implementation of the WBG assistance program to Ecuador in recent years offers lessons that have been considered in the preparation of this DPF.** However, the World Bank has not financed a policy-based operation in Ecuador in more than a decade. Following a suspension of World Bank-financed activities in Ecuador in 2007, the World Bank followed a gradual reengagement process starting in FY14 that has generated some important lessons reflected in the design of the DPF series, as follows:

- **Advisory Services and Analytics (ASA) provide an important platform to inform policy dialogue and identify options for reform**. A rich body of analytical work has been instrumental to generate a deeper understanding of the country's issues, increase evidence-based decision making, and facilitate collaborative interactions between key players, facilitating the design of the operations.
- **Close implementation support, given limited institutional capacity, is critical for achieving results.** Effective and timely implementation of projects has been challenging due to weak institutional capacity for preparing and implementing projects and reforms. For this reason, this operation is being accompanied by a number of technical assistance activities that bridge knowledge gaps and inform the design of reforms in line with sound international practices.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

34. **The programmatic DPF proposes three pillars that seek to help Ecuador achieve a more fiscally sustainable path, with a greater participation of the private sector, and that protects vulnerable groups. Importantly, the three proposed pillars are interlinked and mutually reinforcing.** Efforts to promote a more efficient mobilization and allocation of government resources under Pillar 1 are expected to reduce the Government's footprint, crowd-in private investment, and enable a gradual adjustment in prices. Pillar 2, which aims at removing barriers to private sector development through improvements in productivity will likely generate better jobs, thus improving household income, and will increase activity and fiscal revenues. Pillar 3 ensures that the dividends of Pillars 1 and 2 reflect on better outcomes for vulnerable segments of the population. It helps mitigate adverse impacts of the fiscal adjustment, while promoting participation of these segments in formal labor market and facilitating access to financial markets.

Pillar 1: Promote a more efficient mobilization and allocation of government resources

35. **Actions under Pillar 1 promote improvements to the mobilization and allocation of government resources, supporting an orderly fiscal consolidation.** Weak budgetary processes and current spending rigidities have prevented a more strategic approach to fiscal adjustment, forcing the Government to rely on large capital spending cuts to address fiscal imbalances in recent years. Relatively low non-oil revenues added to fiscal pressures. Reforms proposed under Pillar 1 seek to address these challenges. They help strengthen MEF's capacity and oversight during budget preparation and execution, aligning budgetary processes and public investment planning with fiscal sustainability objectives, in line with international best practices. Reforms also help improve procurement and personnel processes, allowing for savings on goods and services and personnel spending. Additionally, reforms support changes in the pricing of energy

products, reducing Ecuador's large and poorly-targeted subsidies and creating incentives for increasing productivity. Finally, reforms under Pillar 1 support a more efficient revenue mobilization by rationalizing tax expenditures and improving tax policy.

Strengthening budgetary processes and aligning them with fiscal sustainability objectives

Prior Action #1 DPF 1: The Borrower has adopted measures to strengthen its budget preparation process by: (i) establishing budget processes and milestones, including the preparation and sharing of fiscally consistent ceilings for all public institutions covered by the budget; (ii) strengthening MEF's role on budget forecasting and programming, and (iii) endorsing the Principles of the Coalition of Finance Ministers for Climate Action.

Indicative Trigger #1 DPF 2: The Borrower has amended the Organic Code of Planning and Public Finance to introduce a medium-term fiscal framework, revised downwards the current margin of 15 percent for changes in the budget without consulting the National Assembly, and created an integrated national and subnational public investment system.

36. **Rationale.** As the Government proceeded with its first budget preparation cycle after committing to a fiscal adjustment path under the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability, it faced several challenges that undermined its fiscal sustainability objetives. Ecuador lacks budget preparation procedures and milestones that ensure consistency between the macro-fiscal programming exercise and the annual budget programming. This is particularly the case regarding the definition of available fiscal space and of budget ceilings that ensure consistency between the programming process of the annual budget and deficit targets. Multi-year planning is also weak. Investment projects rarely consider operation and maintenance expenses associated with the new asset. During more than a decade, budget preparation has followed a bottom up approach with no aggregate, sectoral, or institutional ceilings. On the investment side, prioritization among projects remains a challenge. Budget projections are based on inputs from many institutions, with limited coordination and consistency checks between them. Ecuador lacks technical instances and formal coordination arrangements to ensure consistency between macro-fiscal programming and the formulation and approval of the annual budget before submission to the National Assembly. Finally, there are aspects contemplated in the budget code that depart from good practices and international standards. The code allows modifications of up to 15 percent of the approved annual budget. Because of this, adjustments are made permanently throughout the budget execution term, reaching more than 4,000 modifications annually and undermining fiscal discipline. Since 2015, ex-post deviations between approved and executed budget have stayed above 20 percent.

37. **Substance of the Prior Action.** The Government is committed to addressing these challenges. Prior Action #1 focuses on regulatory changes that can be introduced by the Executive and can have an immediate impact on the 2020 budget preparation cycle. It creates a budget preparation calendar with clear milestones and deadlines that ensure consistency between budget programming and fiscal policy objectives. The regulatory reform establishes fiscally consistent aggregate ceilings and ceilings for budgetary institutions, that are appropriately shared with institutions at the beginning of the budget preparation cycle. The regulation also simplifies budget forecasting and programming, strengthening the

roles and responsibilities of MEF at this stage. Finally, the Prior Action recognizes Ecuador's adherence to a newly-formed Coalition of Finance Ministers for Climate Action and endorsement of a set of six common principles, known as the *"Helsinki Principles,"* that promote national climate action through fiscal policy and the use of public finance.

38. Indicative Trigger #1 for DPF 2 introduces deeper changes through the enactment of a new budget code. These changes include a downward revision to the 15 percent ceiling for non-consulted budget modifications and the introduction of a medium-term fiscal framework. The Indicative Trigger also establishes the legal framework for an integrated public investment system, establishing roles and mandates for all government entities. It includes principles, technical standards, and procedures for the formulation, evaluation and execution of public investments.

39. **Expected Results and Indicators.** The implementation of reforms to the budget preparation and execution processes and institutions are expected to increase the budget's reliability and consistency with fiscal policy goals. In this context, the difference between the approved and the executed budgets is expected to decline from 16.3 percent in 2017 to 10 percent in 2021.

Increasing the efficiency of spending in goods and services and personnel

Prior Action #2 DPF 1: The Borrower has improved spending in goods and services by issuing a resolution that introduces a strategic approach to procurement, through expanding the use of framework agreements and competitive processes.

Indicative Trigger #2 DPF 2: The Borrower has made spending in personnel more efficient by issuing a Presidential Decree introducing changes to: (i) its salary structure, particularly the pay scales, and (ii) the pay-for-performance system; and it has further improved spending in goods and services by amending the Procurement Law to improve transparency and competition in public biddings.

40. **Rationale.** Fiscal adjustment efforts to date have relied mostly on capital spending cuts. The Government has faced difficulties adjusting relatively rigid current spending on goods and services and personnel. While spending on personnel declined by a modest 0.2 percent of GDP between 2016 and 2018, spending for goods and services increased by 1 percent of GDP in the same period. The analysis developed by the Ecuador PFR suggests that there are opportunities to allocate resources more efficiently by promoting savings in the purchase of goods and services (Figure 3). Data for procurement during 2013-2017 showed that about 50 percent of the value was awarded using non-competitive procurement methods. These methods resulted in higher prices when compared to competitive methods, such as framework agreements and catalogues. Detailed analysis of the data also unveiled a pattern of "over specification" of items, which contributed to higher prices while surpassing the expected functionality and needs for these items. Data seems to indicate that specifications were based on available budget for procurement rather than on functional needs.

Figure 3: Opportunities for saving in public procurement

	Variable with impact on prices	Savings	Suggested policy or strategy
Directly impacted by procurement policies or strategies	Quantity	7.3%	One main contract to supply 80% of the annual demand of goods of high volume and low complexity.
	Procurement method	2.5%	(1) To expand the use of e-catalogues for goods of high volume and low complexity; (2) to deploy reverse auctions more selectively, for goods of low complexity and competitive markets; (3) to curb noncompetitive procurement, especially for "menor cuantía" and "regimen especial" procedures.
	Time to award a contract	1.3%	To implement electronic processes that are more dynamic and efficient to support award processing.
	Seasonality	1%	To improve procurement planning and more predictable budget releases so as to avoid large concentrations of procurement in the last months of the year, and smooth distribution along the year.
	Bidding success ratio	0.5%	To modernize procedures and information availability for contract management, with the goal of curbing cost and schedule overrruns. To train officials in charge of contract management.
	Time allowed to prepare and submit bids	0.3%	To allow more reasonable time for bidders to prepare responsive bids.
	Publication of bidding opportunity	0.3%	(1) To publish an electronic request for bids for simple procedures; and (2) to notify electronically all registered bidders of any bidding opportunity on their area of business.

	Variable with impact on price	Savings	Suggested policy or strategy
Indirectly impacted by Procurement policies or strategies	Number of bidders	2.4%	(1) To approach bidders with a view to understand the barriers to sell to the government; (2) to curb required documentation to submit bids for low complexity items; (3) to process payments quicker; (4) to develop market strategies based on the supply positioning matrix.
	Market concentration	1.8%	To develop customized procurement strategies for the markets that showed highest levels of concentration, based on market competitiveness and end-user needs.
	Supplier specialization	0.7%	To use competitive methods for categories where there are manufacturers.
	Supplier size	0.5%	The strategies suggested to quantities and procurement methods would already impact this variable. Moreover, a survey to understand the barriers and difficulties to prepare a responsive bid would help design effective strategies.
	Buyer concentration	0.2%	To develop a capacity building program to agencies with highest levels of concentration.
	Supplier origin	0.2%	To foster participation of foreign suppliers in markets with low competition, high levels of concentration or where innovation is an important element.
	Supplier province	0.2%	To develop an outreach program to local suppliers, through electronic newsletters and training workshops on how to identify bidding opportunities and to prepare responsive bids.

Source: Ecuador PFR Phase I - 2018

41. The Ecuador PFR also suggests that there are opportunities to contain increases in the public wage bill. Ecuador's wage bill almost doubled as share of GDP since the early 2000s, and without reforms it would continue to grow. Salary levels are higher than in other comparable countries and in the private sector. Inefficient human resource management explains the high personnel expenditures. Inefficiencies include lack of strategic work force planning, numerous salary structures, compensation not related to performance and distorted career incentives. This unreliable system erodes performance and opens opportunities for duplication and even irregularities. Recent efforts to contain the growth of the wage bill focus on wage freezes and salary cuts for high-ranking officials, with some results in 2018. Still, further adjustments require deeper reforms in human resource management.

42. **Substance of the Prior Action.** Prior Action #2 tightens procedures and requirements for noncompetitive procurement methods, which have resulted in higher prices. It consists of issuing a

regulation promoting transparency and competition for public contracts by shifting a portion of the awarded value to competitive methods that are open to participation by all qualified bidders. It also aims to maximize the use of framework agreements and catalogues that will speed up availability of inputs, shortening procurement lead times while ensuring minimum standards for quality and delivering more value for money.

43. Indicative Trigger #2 deepens these efforts through reforms to the procurement code, taking into consideration many of the findings from the PFR in that it: (i) tightens the conditions for use of "*regimen especial*", which the PFR analysis found to result in higher prices; (ii) enables SERCOP to monitor and fight monopolies and oligopolies in public procurement at the buyer level; (iii) adds a pre-bidding stage to help improve planning, and (iv) removes awards based on raffles and direct selections, among other things. Indicative Trigger #2 also reforms the Government's salary structure, particularly the pay scales supporting career progression, thereby generating savings. The Indicative Trigger also revamps the pay-for-performance system, generating incentives for higher productivity in the civil service.

44. **Expected Results and Indicators.** The implementation of reforms on public procurement and human resources are expected to generate more efficient, transparent, and accountable systems, resulting in fiscal savings from expenditures in personnel and the purchase of goods and services. In this context, total spending in goods and services and personnel is expected to decline from 14.7 percent of GDP in 2017 to 13.8 in 2021. This result reflects a decline of 1 percent of GDP of the wage bill, plus an effort to bring spending in goods and service back to 2017 levels from a peak of 5.8 percent of GDP in 2018.

Reforming energy pricing policies to rationalize subsidies and reduce fiscal costs associated with the energy sector

Prior Action #3 DPF 1: The Borrower has issued decrees and regulations to: (i) eliminate subsidies for premium gasoline, industrial diesel, and natural gas for commercial and industrial use and reduce subsides for other fuels, and (ii) strengthen the Regulatory Agency for Hydrocarbon's mandate/governance by granting this Agency the responsibility of setting final prices of fuel products.

Prior Action #4 DPF 1: The Borrower has reduced electricity subsidies by issuing regulations to: (i) improve targeting of social tariffs; (ii) eliminate subsides to off-peak electricity industrial tariffs, and (iii) enforce effective pricing discipline by reducing non-payment and arrears.

Indicative Trigger #3 DPF 2: The Borrower has issued a decree ensuring the fiscal separation between the hydrocarbon sector SOEs and the general government accounts; the Borrower has amended the Organic Law of Public Service of Electric Energy to allow, inter alia, the inclusion of all costs as bases for tariff calculations.

45. **Rationale.** Energy price subsidies absorb a large amount of fiscal resources which mostly benefit those that are relatively well off. For example, price subsidies for liquid fuels are estimated at around 2.3 percent of GDP in 2017. These subsidies are paid for through government outlays and financial losses borne by the national oil company. The total subsidy cost also includes financial losses and forgone

revenues by the electricity distribution utilities. The top 60 percent of the income distribution received between 80 and 92 percent of the gasoline and diesel subsidies.[18] Subsidies are set through *ad hoc* and inefficient pricing revisions that do not reflect a long-term policy to target the most needed beneficiaries. Price controls and subsidies have resulted in lack of competition and inefficiencies in the downstream energy sector, which is dominated by Petro Ecuador, the state-owned downstream company that holds a monopoly on imports and distribution of fuels save in the retail sector.

46. Until recently, prices of hydrocarbon products were set freely and in an *ad hoc* manner by the President. These prices were frequently well below production costs, explaining the high subsidy bill. Tariffs for electricity are set by the regulatory agency (ARCONEL), based on a cost-plus tariff formula that takes into account operational costs, but excludes capital expenses, which are absorbed by the Government. The targeting of residential and industrial electricity subsidies through the current schemes is also poor, with significant errors of inclusion and leakages that do not ensure that tariffs paid by non-subsidized consumer categories correspond to efficient costs.

47. **Substance of the Prior Action.** Prior Action #3 reforms fuel pricing mechanisms for selected products, eliminating price subsidies for these products and rationalizing subsidies for the remaining fuels. In December 2018, the President issued Decree #619 eliminating subsidies for premium gasoline and diesel for industrial use by mandating that the prices for these products be set to match production costs. The Decree also increased prices for other fuels, reducing the amount of subsidies paid. This Decree was complemented by an additional Decree that grants price setting responsibilities to the hydrocarbon regulatory agency (ARCH). These combined efforts will lead to estimated savings of approximately 0.4 percent of GDP.

48. Prior Action #4 reforms electricity pricing to rationalize subsidies for residential and industrial consumers, enhance payment discipline and promote efficiency through the reduction of non-technical losses. It revises the criteria for residential consumers to qualify to receive social tariffs (the so called "*tarifa de dignidad*"). The new eligibility criteria to receive the social tariff, require that consumption be kept below the refence thresholds (10 kWh in the Sierra, and 130 kWh in the Coast, Amazon and Insular Regions) for 11 months per year (instead of around half a year). This is expected to result in budget savings estimated to about US$11 million, as well as reduction of the financial losses borne by the electricity distribution utilities. This effort is complemented by the elimination of subsidies to off-peak industrial tariffs. This tariff rebalancing is estimated to result in budget savings of US$60 million, as well as reduction of the financial losses borne by the electricity distribution utilities. ARCONEL regulation 004/18 allows the distribution company to disconnect users who do not pay and provides specific regulation for pre-payment, post-payment and electronic payment, enhancing effective pricing discipline and reducing arrears and non-payment and enhancing efficiency through reducing non-technical losses. These actions are expected to result in higher average tariffs for users that are not poor or vulnerable and should thus reduce electricity use and result in combined fiscal savings of approximately 0.1 percent of the GDP.

[18] Subsidy calculations are based on opportunity costs which are import-parity costs for gasoline, diesel and LPG and export-parity for heavy fuel oil. For further information about how these figures were estimated see Annex IV.

49. Indicative Trigger #3 supports the separation between the central government and oil sector SOEs' accounts, allowing for more transparency and better management of remaining subsidies and other fiscal liabilities associated with this sector. This Indicative Trigger also contemplates a reform to the Organic Law of Public Service of Electric Energy that allows the inclusion of all costs including capital expenses as a basis for the electricity tariff calculation. This change could lead to fiscal savings of an additional 0.5 percent of the GDP.

50. **Expected Results and Indicators.** These Prior Actions support, directly and indirectly, reductions on energy subsidies. Results will be measured by energy subsidy spending as a share of oil revenues, which is expected to decline from 38.3 percent of GDP in 2017 to 37.1 percent in 2021. By helping align energy prices with market values, these reforms will also curb excess consumption and wasteful production, contribute to lower carbon emissions and support the Government's climate change mitigation objectives under the intended nationally determined contributions to the Paris Agreement goals.

Improving resource mobilization

Indicative Trigger #4 DPF 2: The Borrower has reformed its tax structure to increase revenue collection and reduce distortions.

51. **Rationale and Substance.** Part of the Government's fiscal consolidation efforts stem from a more efficient mobilization of non-oil revenues. While tax administration reforms helped increase revenue collection in the past decade, tax revenues (18.7 percent of GDP in 2018) are low compared to regional peers (22.8 percent on average). Revenue performance is affected by narrow bases and, in some cases, relatively low rates. Tax expenditures reached 4.5 percent of GDP in 2017, above the regional average (3.5 percent). The PFR noted that a share of these expenditures is poorly targeted and does not fulfill intended objectives. For example, personal income taxes (PIT) deductions benefit almost entirely the top quintiles of the population and many products subject to a zero-rate value added tax (VAT) are mostly consumed by the rich. The economic literature provides mixed (if not limited) evidence on the benefits of corporate income taxes (CIT) exemptions as a tool to encourage investment. The Government has intensified the use of this instrument since 2017. in efforts to promote private investment, but design has not considered fiscal policy objectives and could further undermine revenue collection in the future. The VAT rates are also low. At 12 percent, the VAT rate is the lowest among Latin American countries. Income tax rates are also below the regional averages[19]. However, Ecuador's tax system also includes less traditional sources such as import tariffs, tax on capital outflows (ISD), and a mandatory redistribution of profits to workers, which are very distortive.

52. Indicative Trigger #4 consists of a structural tax reform that will align tax rates to regional standards. It will reduce distortions in the tax system, while improving revenue collection. For example, it will allow for the phasing out of the distortive ISD. In addition, the reform will rationalize tax expenditures by reforming a range of tax deductions and tax benefits, limiting poorly targeted deductions to PIT, imposing a positive VAT rate on selected non-basic products, and introducing annual ceilings to CIT tax

[19] Ecuador PFR 2018.

benefits in line fiscal targets. The World Bank and the IMF are providing technical assistance for the preparation of this reform.

53. **Expected Results and Indicators.** This Indicative Trigger is expected to expand the tax base, reduce distortions and improve revenue collection in the medium term. Progress towards this goal will be tracked by a 1.4 percent of GDP increase in tax revenues[20] from 13.5 percent in 2017 to 14.9 in 2021.

Pillar 2: Remove barriers to private sector development

54. **Actions under Pillar 2 focus on removing barriers for private sector development.** By doing so**,** these reforms will contribute to higher productivity and competitiveness. The appreciation of the real exchange rate, in the presence of rigid labor laws in a dollarized economy registered in the past decade, has contributed to a loss of competitiveness of the tradable sectors of the economy. In addition, some of the policies that accompanied the expansion of the state's footprint in the economy were harmful to private sector development. Several barriers, including regulatory uncertainty, high costs to open and close businesses, constraints to imports, and distortions in financial markets have negative effects on the productivity of the private sector. Previous administrations enacted a series of legal changes that stymied private investment (domestic and foreign). For example, the Government changed the structure of oil contracts to retain a higher share of oil revenues during the oil price boom at the same time as it withdrew from International Center for Settlement of Investment Disputes (ICSID). Regulatory changes have also affected importing and exporting firms. In addition, the time and costs involved in registering a new business in Ecuador are high compared to regional peers. Access to finance is also considered by business to represent an important obstacle. Regulatory barriers limit financial sector performance. For example, interest rate ceilings exclude borrowers priced out of formal credit markets under current caps. Also, the regulation includes mandatory banks' credit allocations to selected financial institutions, including public banks and large corporations. Public banks play an important role in financing the economy but face challenges related to the structure of funding, transparency and accountability, and mandate. In many segments, public banks compete with private ones. Tackling these barriers could foster a more dynamic private sector by boosting private investment and promoting a more efficient allocation of factors of production across firms.

Reducing contractual uncertainty and mitigating regulatory risks

Prior Action #5 DPF 1: The Borrower has adopted provisions to require the inclusion of international arbitration clauses in large contracts.

Indicative Trigger #5 DPF 2: The Borrower has amended the Fiscal Incentives Law to align it with best international practices on Public Private Partnerships (PPPs) to, among others, clarify at a strategic level the roles and responsibilities of the different government agencies along the PPP project cycle and decision-making process.

[20] Excluding social security contributions.

55. **Rationale.** The SCD highlights contractual and regulatory uncertainties as key impediments to private investment. Ecuador's Constitution (Article 190) and legal framework significantly restricted the use of arbitration in a dispute between parties in an international court and limited arbitration to sites within the Latin America region. During the previous administration, Ecuador pulled out of ICSID and imposed a Constitutional restriction to re-joining it. These restrictions have increased the perceived risks for the private sector, as international investors and financiers are interested in fair settlement systems, which include the possibility of international arbitration. Restrictions to arbitration have been one of the main barriers to foreign investment inflows into Ecuador, which stand as among the lowest in LAC. They are particularly restrictive to large investment projects in the oil sector and infrastructure and are becoming particularly binding as Ecuador progresses with complementary reforms to enable private sector participation in these segments. For example, the Government modified the Hydrocarbons Law to introduce production sharing agreements for new exploration and production contracts in the oil sector, which sets favorable conditions to attract private investments to this sector. The Government is also working on setting a regulatory framework and institutional setting for PPPs. The lack of this regulatory and institutional setting has limited the use of PPPs to mobilize private finance for needed infrastructure investment. Combined, these reforms can have a larger impact on mobilizing private investment.

56. **Substance of the prior action.** Prior Action #5 makes mandatory the inclusion of international arbitration in contracts for large investment projects sponsored by the Government. This is part of a series of measures aimed at re-establishing Ecuador's appeal as an investment destination introduced under the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability. Prior to this reform, the National Arbitration Law stipulated that international arbitration clauses were possible only if agreed to by the Government and approved by the General Attorney's Office. After the enactment of the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability, all contracts for large investments (above US$10 million) must include an international arbitration clause, which is reviewed by the Attorney General's Office to insure it is consistent with the Law. To reinforce this reform, the Minister of Production, Trade, Investments, and Fishing also signed a Memorandum of Understanding with a regional arbitration center, the Arbitration Center of the Chamber of Commerce of Santiago in Chile, where both parties recognize each other; the Government commits to participate in arbitration following high standards of transparency and the Center agrees to be prepared to offer services as requested. While most countries allow the use of international arbitration centers such as ICSID, the Ecuador's Constitution explicitly excludes such possibility. In the interpretation of the Attorney General's Office, the location of international arbitration needs to be within the Latin America region. In this context, the Arbitration Center of the Chamber of Commerce of Santiago has a long tradition of arbitration in domestic and international cases that can bring confidence to investors about fair mechanisms for dispute resolution. These reforms signal the Government's commitment with the protection of investor's rights.

57. In a second stage, the Government will amend the Fiscal Incentives Law, Indicative Trigger #5, to address weaknesses in current regulations and define institutional arrangements for the structuring of PPPs. The reform will: (i) clarify, at a strategic level, roles and responsibilities of the different government agencies along the PPP project cycle and decision making process; (ii) incorporate PPPs into the budget, debt and risk management processes; (iii) regulate the process for unsolicited proposals; (iv) harmonize the various PPP regimes applying to different sectors and/or government institutions (including SOEs), and

(v) create a PPP project structuring unit, and a unit in MEF responsible for PPP policy, contract registry, and the management of explicit and contingent guarantees. The PPP reform aims at boosting private investment in public infrastructure, while allocating risks among different stakeholders and fostering private sector financing.

58. **Expected Results and Indicators.** This Prior Action will facilitate foreign investments in the country, especially on large projects, by giving options to investors in their mechanisms for dispute settlement. Greater foreign investments will support economic growth and employment creation. The PPP Law is expected to create conditions for private sector participation in necessary infrastructure projects, while opening fiscal space for other priority expenditures. Progress towards these objectives will be tracked by the number of new investment projects, with contracts for more than US$50 million that allow for international arbitration, including PPP contracts in the tender process. This number of projects is expected to shift from 0 in 2017 to at least 3 in 2021.

Creating conditions for a more dynamic private sector

Prior Action #6 DPF 1: The Borrower has adopted measures to facilitate firm entry, by: (i) including provisions in the Productive Law to strengthen the Limited Liability Modality for firms, and (ii) eliminating the obligation for importers to prove compliance with national technical requirements prior to arrival, replacing it with a posteriori risk-based control.

Indicative Trigger #6 DPF 2: The Borrower has enacted a law and approved regulations introducing a simplified regime for registering a corporation.

59. **Rationale.** Entrepreneurial decisions are shaped by costs associated with entry, exit and firm operations. Entrepreneurs are more willing to enter new markets, experiment and innovate, and invest in new growth opportunities if they face low entry and exit costs, and have the legal assurances that such costs will not increase in the future.

60. In the last decade, Ecuador's regulatory environment became less conducive of a dynamic role of the private sector. For example, it takes 48.5 days for an entrepreneur in Ecuador to start a business, almost twice the LAC average and five times the average for OECD high income countries. The limited liability[21] principle did not exist in practice in Ecuador since the publication of the Organic Law for the Defense of Labor Rights on September 26, 2012. The Law stipulated that shareholders and their inheritors were personally liable for the company's debts or liabilities related to labor obligations. Regulation has also discouraged the use of high-quality imported goods due to high tariffs and non-tariff measures. Average effective tariffs increased by 2 percentage points from 2008 and 2016 and non-tariff barriers stand among the highest in LAC. These included licenses and onerous technical specification and validation processes. Ecuador is increasingly subject to specific concerns at the World Trade Organization (WTO)'s

[21] The concept of limited liability refers to the fact that the shareholders of a company are liable only to the extent of the capital that they invested in the company. If the company falls into unsustainable debt and ends up in the hands of administrators, the personal assets of the company's shareholders are not at risk as only their capital contributions can be used to pay the company's debts.

Technical Barriers to Trade Committee, especially since 2013, and since 1995 more cases have been filed against Ecuador than for regional peers (except for Brazil).[22] Amid these obstacles, firm dynamics have slowed in Ecuador in recent years. Net entry rates have declined steadily over the past five years in all sectors, and so have firm survival rates and growth.

61. Barriers to entry, exit and growth affect disproportionately young and small firms, which represent the bulk of Ecuador's private sector. In 2015, more than 97 percent of firms were micro and small firms and nearly 40 percent were less than five years old. Existing research shows that while young firms are on average relatively smaller in terms of sales than incumbents, they generate on average relatively more jobs.[23] However, less than half of the firms created in a year manage to survive more than five years. High operating costs affect disproportionately the survival and growth potential of these firms because they account for a larger share of their sales.

62. **Substance of Prior Action.** Prior Action #6 considers a package of laws and pertinent resolutions facilitating entry of firms by: (i) reintroducing the concept of limited liability, and (ii) reducing Ecuador's relatively high import costs by addressing non-tariff barriers. The Government reintroduced the limited liability principle on August 21, 2018 through the Article 46 of the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability that eliminates the Article 1 of the Organic Law for the Defense of Labor Rights. This change, in combination with the current legal framework on liabilities towards tax and financial obligations, strengthened the limited liability principle by eliminating a major source of legal uncertainty. In addition, reducing non-tariff barriers will lower the cost of households' basic consumption basket, and support domestic industries that need imported intermediate goods. On November 26, 2018, the Government eliminated Resolution 116 of 2013, removing the requirement that importers prove compliance with 50 national technical requirements covering 259 tariff lines prior to arrival and replaced it with a posteriori control following a risk management strategy. The list of goods includes household consumption goods that weigh relatively more in the expenditure structure of poor households, such as dairy and derivates, cooking oil, coffee, meat derivates and energy-efficient appliances, as well as products used as inputs by other sectors, including packaging material and cement.

63. Indicative Trigger #6 introduces the possibility of registering companies within a simplified regime. This will reduce the fixed cost to register a business by: (i) reducing the minimum social capital to be paid up to one year after firm registration, and (ii) eliminating the need to hire a lawyer and a notary. This reform will support economic dynamism, especially of small firms, and facilitate the registry of new startups.

64. **Expected Results and Indicators.** The implementation of comprehensive business registration reforms is expected to lower barriers to entry and encourage formal registration of firms. Economic literature and empirical evidence suggest that policies aimed at reducing regulatory barriers to entry can

[22] While such measures might address legitimate public policy objectives (i.e. health, environment or safety concerns), they are not always aligned to international standards, the Ecuadorian private sector's capacity to comply is low, and considerable gaps remain in the NQI. For example, conformity assessment bodies can provide certifications for only 36 percent of technical regulations.

[23] INEC 2017, Panorama Laboral y Empresarial del Ecuador.

have positive effects on firm registrations, formal job creation, and productivity.[24] Overly restrictive technical regulations and excessive paperwork to demonstrate compliance can act as non-tariff barriers, limiting domestic competition by increasing import costs[25]. Facilitating access to inputs through lower import costs and streamlined procedures will reinforce these positive effects. The proposed indicators to track these effects during the DPF implementation period are: (i) the number of new commercial companies registered, which is expected to increase by 31 percent, from 8,210 in 2017 to 10,800 in 2021, and (ii) average import time [26], which is expected to drop by 12 percent from 4.9 days in 2017 to 4.3 days in 2021.

Reducing regulatory distortions in the financial sector

Prior Action #7 DPF 1: The Borrower has reduced distortions on the banking sector by issuing regulations to: (i) eliminate new Central Bank investments in public financial institutions, and (ii) increase bank liquidity by considering allocations to the Liquidity Fund as part of the amount required by the Domestic Liquidity Requirement.

Indicative Trigger #7 DPF 2: The Borrower has reduced financial distortions by: (i) reforming the governance and sources of funding of public banks, (ii) partially liberalizing interest rate ceilings, and (iii) reforming the Financial and Monetary Code to allow banks to have subsidiaries that foster capital market development.

65. **Rationale.** The banking sector in Ecuador is subject to several regulations that inhibit its capacity to deliver financial services to several segments of the population. Privately owned commercial banks face competition from less regulated financial intermediaries, such as cooperatives and public banks, that have fewer demanding regulations in terms of solvency, liquidity and governance. In addition, lending operations are subject to interest rate ceilings that are not necessarily market driven, and that limit the commercial viability of lending operations to various segments of the population. In addition, the Central Bank has been a significant source of medium- and long-term low cost of funding for public banks. In some cases, these resources were used to finance the central government, and in others to finance the regular operations of public banks. In addition, the Monetary and Financial Code Regulation imposes two requirements to manage banks' liquidity: the minimum liquidity requirement and the domestic liquidity requirement. The last one requires a minimum share of liquid assets to be invested domestically. Since a significant part of eligible domestic instruments are relatively illiquid, the liquidity of banks is not being protected by these two requirements.

66. **Substance of the Prior Action.** The Government is committed to restoring financial market efficiency. In this spirit, Prior Action #7 removes the possibility of Central Bank financing of public banks, which limits the possibility of quasi-fiscal operations, thus strengthening macroeconomic resilience and

[24] Research in Mexico (Bruhn, 2011; Bruhn 2013; Kaplan et al, 2011), Peru (Mullainathan and Schnabl, 2010), Colombia (Cárdenas and Rozo, 2009) and Portugal (Branstetter et al, 2010) documented an increase in business registration rates following business registration reforms.
[25] Cadot and Gourdon (2017), Non-tariff measures, preferential trade agreements, and prices: new evidence, Review of World Economics, 152: 227-249.
[26] Including time for nationalization and customs procedures.

helping level the playing field in terms of costs of funding between private and public banks. In addition, prior action 7 helps increase the effective liquidity of commercial banks, by interpreting their investments in the Liquidity Fund as domestic investment, for the purposes of calculating the Domestic Liquidity Requirement. This interpretation is consistent with the treatment of the Reserve Requirement (*encaje*) as domestic investment for calculating the Domestic Liquidity Requirement. This measure will provide commercial banks with more domestic liquidity for regulatory purposes. Banks may want to use this opportunity to better manage their assets allocation and increase domestic lending. Close monitoring of the implementation of the reform and the broader impact on financial sector will help revert a declining trend in credit growth and attenuate the growth impact of the fiscal adjustment.

67. These initial steps will be followed by Indicative Trigger #7 which aims to remove distortions in the financial sector. It improves the governance of public banks and revises their mandate to complement private banks. It also creates conditions for more transparent sources of funding of public banks, including substitution of the current requirement for private banks to allocate part of their liquidity to funding of public banks. [27] Public banks will need to become more efficient, and improvements in their governance capacity will be essential for achieving that objective. In that context, public banks are expected to focus on addressing market failures and playing a catalytic role for supporting the participation of privately-owned banks in segments of the market that currently are not served. Indicative Trigger # 7 also supports the initial steps for interest rate liberalization by revising the criteria for determining the ceilings in different segments, including consumption lending. While further interest rate liberalization will help to better allocate resources, the timing and steps need to be carefully crafted in order to create consensus among different actors. The initial steps for interest rate liberalization will allow further adjustments in order to gradually converge to market interest rates for different segments of the market. Finally, it expands the activities that banks can develop through subsidiaries, including securities brokerage and Fintech.

68. **Expected Results and Indicators.** The elimination of Central Bank funding to public banks will reduce distortions in the financial sector by avoiding subsidized funding to public banks and limiting quasi-fiscal operations. The lifting of the restrictions on the Domestic Liquidity Requirement will increase available liquidity for commercial banks and could help revert the ongoing slowdown in credit growth, attenuating the growth impacts of the fiscal consolidation. The set of actions in the Indicative Trigger will expand the possibilities of the banking sector to serve new segments of the population and the corporate sector and will focus the role of public banks into sectors where the privately-owned banks have been unable to serve. In addition, they will reduce implicit subsidies on the public banks' cost of funding. These results will be monitored by: (i) co-movement[28] between interest rate ceilings and nominal interest rates charged by banks for ordinary consumption, from 0 in 2017 to > 0.2 by 2021, and (ii) participation of second

[27] The minimum liquidity requirements (MLR) are calculated as a percentage of bank deposits and other bank liabilities. The MLR are required to be invested in institutions and instruments, according to certain minimum thresholds. These minimum thresholds are defined by Resolution of the Commission of Monetary and Financial Regulation. The current resolution establishes minimum investments in instruments issued by public banks and deposits at the Central Bank of 3 percent.

[28] Co-movements are proxied by the ratio between standard deviation of monthly interest rate ceiling and the standard deviation of the effective interest rate measured with monthly data over an 18-month period.

tier financing in the new lending operations of public banks[29] from 0 in 2017 to 17 percent in 2021.

Pillar 3: Protect and include vulnerable segments of the population

69. **Pillar 3 supports reforms that seek to protect vulnerable segments of the population against the impacts of ongoing fiscal consolidation efforts through well-targeted social programs.** Ecuador witnessed substantial economic and social gains between 2007 and 2014. High economic growth coupled with an improved income distribution helped lift 1.4 million people out of poverty. Macroeconomic vulnerabilities post-2014 affected the Government's capacity to protect the poor. Fiscal pressures led to a decline in public transfers. The reductions were based on an outdated information system that increased exclusion errors, while still including an important share of non-poor in the system. The adjustment reduced the impact of redistribution on poverty reduction between 2014 and 2017. The Government is committed to implementing reforms that can ensure that existing fiscal space is allocated towards effectively protecting the poor and the vulnerable, mitigating the impacts of fiscal consolidation reforms on these groups.

70. **The Government's reform agenda also aims to include vulnerable segments in the process of economic development.** The share of informal workers who earn less than the minimum wage has increased continuously since 2014, reaching three-fifths of informal workers in 2017. The rise in informality could be partially attributed to rigidities in the labor market. This affects the most those engaged in 'low quality' jobs (i.e., jobs with fewer hours, lower pay, less security), especially the young and women. Even though educational gaps are almost negligible between genders, women still face wider access constraints to better quality jobs than men. This is reflected in higher informality and unemployment rates, as well as in lower labor income. The situation is aggravated by Ecuador's relatively high levels of domestic violence, which are shown to adversely affect women's ability to access and sustain income generation activities. [30] Constraints on access to formal credit markets weaken the incentives for informal firms to comply with tax, legal, and social security provisions, leaving these economic activities small and limiting productivity and income growth. Pillar 3 will support reforms to expand economic opportunities and include vulnerable groups into the renewed growth process. These include a labor reform aim at promoting formality and reforms to expand access to financing, especially among vulnerable segments of the population.

Designing well-targeted on social protection and compensation programs

Prior Action #8 DPF 1: The Borrower has: (i) expanded the objectives of the Social Registry, and (ii) approved the creation of a unit within MEF dedicated to the design of compensation mechanisms to mitigate the impact of subsidy reforms. **Indicative Trigger # 8 DPF 2:** The Borrower has implemented a compensation mechanism to mitigate the impact of fuel subsidy (gas, diesel, gasoline, and electricity) price reforms.

[29] Measured as the average new lending of BanEcuador and National Financial Corporation (CFN) during the reference year.
[30] Ecuador SCD (2018).

71. **Rationale.** The Social Registry, created in 2009, is the information system that supports intake, registration and definition of potential eligibility for several social non-contributory programs. It contains information on eight million individuals (roughly two million households), mainly from the bottom 40 percent in terms of per capita consumption. The Registry has been used mainly for targeting non-contributory social programs to the extreme poor. However, there is a need to expand its scope to allow for the design of policy and programs, including compensatory policies to mitigate impact of reforms. A stronger Social Registry can also be an important tool for climate change adaptation, as it will allow for well-targeted emergency response and post-disaster interventions. An improved Social Registry can also address several overlapping vulnerabilities such as economic and climate vulnerabilities. One immediate use for the updated registry is the design of a well-targeted compensation mechanism that will allow the Government to progress further in its energy subsidy reform agenda while ensuring that vulnerable segments are protected from its adverse impacts. The Government is currently defining the institutional setting for the design and implementation of this mechanism.

72. **Substance of the Prior Action.** Prior Action # 8 promotes the improvement of the Social Registry and its use. In August 2018, the Government expanded the scope of the Registry to a range of policy uses, beyond Ecuador's conditional cash transfer program. This new system will support different ministries on the targeting for their existing and new programs, including those for mitigating the impact of energy subsidy reforms. The information in the new registry can also help inform the relevant ministries on climate risk considerations. This requires information about vulnerable segments that goes beyond the extreme-poor. Prior Action #8 also supports the creation of a strategy unit within MEF whose sole mandate is to design and implement compensation mechanisms to mitigate the adverse impacts of energy pricing reforms. Indicative Trigger #8 supports the design and implementation of the different compensation mechanisms.

73. **Expected results and Indicators:** Prior Action #8 is expected to increase the scope of the Social Registry beyond the first and second quintile to mitigate the impact of subsidy reforms. Indicative Trigger #8 will further support the design compensation programs. These results will be tracked by the increase in the share of household at the bottom 40 of consumption distribution receiving compensation from a baseline of 0 percent in 2017 to 80 percent in 2021. The stronger Social Registry is also expected to contribute to climate change adaptation, by providing accurate information to targeted emergency response and post-disaster interventions.

Reforming labor markets to increase access to formal jobs

Prior Action #9 DPF 1: The Borrower has enacted a new law and regulatory framework aiming at preventing and eradicating violence against women to, *inter alia,* improve their economic opportunities. **Indicative Trigger #9 DPF 2:** The Borrower has approved a labor reform aimed at promoting formality, particularly among vulnerable segments of the population such as women and youth.

74. **Rationale.** Underemployment and informality are relatively high in Ecuador, and disproportionally high for women and youth. Widespread violence against women is one of the elements limiting economic opportunities for this group. According to the last National Survey on Gender-Based Violence (INEC 2011), 35 percent of women reported that they had been victims of physical violence by a partner. Meanwhile, 43 percent of women have been exposed to psychological violence and 14.5 percent have experienced sexual violence by a partner. Violence against women carries significant costs, amounting to nearly 2 percent of global GDP or US$ 1.5 trillion[31.]. Violence against women and girls creates negative impacts on women's participation in education, employment and civic life. Women may suffer isolation, inability to work, loss of wages, job instability, and lack of participation in regular activities[32]. For instance, in Peru, studies estimating the cost of domestic violence find that the economic costs totaled US$6.7 billion[33,], equivalent to a 3.7 percent loss in GDP resulting from decreased productivity[34]. On average, female victims lost between 43 and 47 productive days of work during the year studied[35]. While there are no similar studies for Ecuador, economic impacts are likely to be as significant.

75. Underemployment and informality have been rising since 2014 largely due to regulatory rigidities such as high minimum wages, mobility costs, and inflexible working hours, that discourage firms from creating formal positions. As economic and labor market conditions deteriorated, more people re-entered the labor force than in the preceding years but most engaged in 'low quality' jobs, especially youth and women. These low-quality jobs offered fewer and more flexible hours per week, but also lower salaries and no protection. Firms tend to respond to labor market rigidity by increasing their reliance on informal labor, which disproportionally affects these vulnerable segments. The net entry rate of workers to the social security registry has been falling since 2012 and became negative in 2015, with stronger trends for women.

76. **Substance of the Prior Action.** Prior Action #9 introduces a legal framework to prevent and eradicate violence against women, with positive impacts on their ability to find and sustain an income-generating activity. This law and associated regulations provide a way to focus government action on the awareness and prevention of violence with the participation of citizens, under the principle of co-responsibility. These two actors must guarantee, through policies, plans and programs, the transformation of sociocultural patterns and the eradication of practices that normalize violence against women. This law also establishes three components for the eradication of violence: care, protection and reparation of women victims of violence to ensure their safety and integrity and to resume their life, job, and family activity. Indicative Trigger #9 supports labor reforms aimed at promoting formalization, especially among vulnerable segments such as women and youth.

77. **Expected results and Indicators:** Prior Action #9 is expected to reflect a gradual shift in the Government's and citizens' strategies, programs, and attitudes, strengthening the prevention and eradication violence against women, ultimately resulting in a safer environment for women to live, study,

[31] (UNWomen 2016)
[32] (WDR 2012, WHO 2017, IWPR 2017))
[33] Estimates drawn from 2011 DHS survey.
[34] (Diaz and Miranda, 2010)
35 (Varna-Horna et al. 2015)

and work. The labor reform, which will be designed with the World Bank's technical assistance, will aim to address constraints on labor market regulations that limit accesses to high quality formal jobs. Therefore, the expected outcome of this reform is to increase formal employment in general and among the vulnerable segment in particular. However, the full implementation and materialization of the impacts of these reforms are likely to go beyond the implementation period this DPF. Therefore, the proposed results indicator will track progress on the implementation steps such as the approval of the regulatory framework associated with the legal reform.

Promoting financial inclusion responsibly.

Prior Action #10 DPF 1: The Borrower has mandated the auditing of CONAFIPS in terms of its capacity to reach vulnerable sectors of the population. **Indicative Trigger #10 DPF 2:** The Borrower has issued regulations strengthening the regulatory framework and supervision for cooperatives and enacted regulations to facilitate the development of an electronic payment system to which vulnerable sectors of the population may have access. This system would need to be connected to the payment system used by commercial banks and cooperatives.

78. **Rationale.** The cooperative sector in Ecuador has grown significantly since 2014 and plays an important role in expanding access to financial services among the bottom of the income distribution. Its capacity to compete with commercial banks is due in part to regulatory and supervisory gaps that allow the sector to take more risk than other financial institutions. To the extent that this regulatory forbearance may put in jeopardy the solvency of some of these cooperatives, it is important to enhance the standards of regulation and supervision of the cooperative sector in order to level the playing field and ensure that the sector counts upon sufficient capital to fulfill its commitments.

79. A central player in the cooperative sector is CONAFIPS, a public bank that offers second tier financing to financial cooperatives (*cooperativas de ahorro y credito*), and other small financial institutions (*cajas de ahorro, bancos comunales and cajas comunales*). As of September 2018, CONAFIPS has 275 eligible institutions for the provision of lending. However, there is limited information about the final allocation of resources by CONAFIPS.

80. **Substance of the Prior Action**. Prior Action #10 supports the transparency and regulation of the cooperative sector and efforts to expand its reach. As part of these objectives, the Borrower will hire an international consultant to assess the allocation of CONAFIPS' credit. The assessment will describe the sectors that have received CONAFIPS' financing and compare this to segments of the population that are more in need. In parallel, the World Bank, as part its technical assistance to the Government, is assessing the solvency of the cooperative sector (Segments 1, 2 and 3). This study will complement the audit and provide inputs for understanding whether CONAFIPS is properly assessing the capital structure of the eligible institutions. Indicative Trigger #10 builds upon the Prior Action by including two additional actions: (i) improvements in the regulatory and supervisory framework of cooperatives, and (ii) introduction of regulation for the development of a payment system to be used by the vulnerable sectors of the economy and integrated to the payment system used by banks and cooperatives. The improvements in the

regulatory and supervisory framework will help to strengthen the financial sector and increase confidence in financial institutions. The development of electronic payment system will support further access to finance by individuals in rural sectors, among others.

81. **Expected Results and Indicators.** This Prior Action will help to target better credit allocation policies of CONAFIPS among eligible institutions, and to evaluate its monitoring capacity regarding the resources that are passed through eligible institutions. The audit will provide inputs for further strengthening CONAFIPS' control systems. The Indicative Trigger will facilitate financial sector intermediaries to compete in a leveled playing field, with well capitalized institutions that serve not only the corporate sector, but also the most vulnerable sectors of the population. The main beneficiaries will be the individuals that have their savings in the cooperative sector, which tend to belong to vulnerable segments of the population. The use of an electronic payment system will facilitate access to financial services by these segments. A greater number of financial institutions, including cooperatives, will be able to offer electronic payment systems to their participants at lower fees, facilitating a greater number of low value transactions. This will include transactions of clients served by the cooperative sector that take place through debit cards. These results will be captured by an expansion of approximately 65 percent in the number of debit card transactions associated to consumption from 33 million in 2017 to 57 million in 2021 (an indicator periodically monitored by the Government).

82. **Table 5: DPF Prior Actions and Analytical Underpinnings**

Prior Actions	**Analytical Underpinnings**
Pillar 1: Promoting a more efficient mobilization and allocation of government resources	
Prior action #1	Ecuador Public Finance Review- Phase I (2018) and Phase II (2019), ongoing technical assistance.
Prior action #2	Ecuador Public Finance Review- Phase I (2018) and Phase II (2019)
Prior action #3 and #4	ESMAP- Sustainable and Equitable Energy Subsidy Reforms in Ecuador (2018-2020), Ecuador SCD (2018)
Pillar 2: Promoting a more efficient mobilization and allocation of government resources	
Prior action #5	Ecuador SCD (2018), Ecuador CPSD (2019)
Prior action #6	Trade, Investment, and Competitiveness ASA (2019), Ecuador SCD (2018), Ecuador CPSD (2019)
Prior action #7	Financial Stability and Inclusion ASA (2019), ongoing technical assistance.

Pillar 3: Protect vulnerable segments of the population through well-targeted social programs and include them in formal economic activities	
Prior action #8	Ecuador SCD (2018), ESMAP - Sustainable and Equitable Energy Subsidy Reforms in Ecuador (2018-2020), ongoing technical assistance
Prior action #9	Ecuador SCD (2018)
Prior action #10	Financial Stability and Inclusion ASA (2019), ongoing technical assistance.

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

83. **The World Bank Group is developing an Ecuador Country Partnership Framework (CPF) FY19-FY23, which aims at rebalancing the economy, reigniting sustainable growth and protecting the vulnerable.** This is the first World Bank Strategy for Ecuador since 2007. The new-CPF is being prepared in parallel to this operation. It focuses on achieving the World Bank Group's twin goals—ending extreme poverty and boosting shared prosperity—through three interdependent areas where expected results are aligned with the Government's priorities outlined in *Plan de Prosperidad* and the key challenges identified by the 2018 Ecuador SCD. These are: (i) Supporting Fundamentals for Inclusive Growth; (ii) Building Human Capital and Protecting the Poor, and (iii) Enhancing Institutional and Environmental Sustainability. Pillars 1 and 2 of the proposed DPF series support CPF objectives under results area (i), while Pillar 3 supports CPF objectives under results area (ii).

84. **The proposed DPF series is closely linked to other World Bank-financed operations, including the Social Safety Net IPF and the Risk Mitigation and Emergency Recovery Project.** As previously discussed, the DPF series benefited from many ASAs and TAs that allowed for the identification and design of critical reforms. The DPF series also complements other World Bank lending operations. Pillar 3 supports regulatory reforms needed for the implementation of the Social Safety Net Project (P167416) whose objective is to improve the equity, integration, and sustainability of selected safety net programs. One of the main sub-components of that project is to support the effective and timely updating of the Social Registry beyond the bottom two quintiles of the per capita consumption distribution. Pillar 1 relates closely to Component 3 of the recently restructured Risk Mitigation and Emergency Recovery Project (P157324). The restructured project includes the mitigation of macroeconomic risks as part of its PDO and expands its Component 3 to support MEF's technical capacity to implement macro and structural reforms that increase resilience against macroeconomic shocks.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

85. **The Government has carried out consultations on the main measures supported by the DPF**. Public deliberation and participation have been a useful—and legally mandated—mechanism to work on overcoming polarization, helping mobilize support to the reforms and mitigate adjustment costs. All legal

reform proposals are made publicly available online and have two open consultation phases of a minimum of 30 days in the National Assembly. The first round takes as its base the initial reform proposal. It includes key actors affected by the initiative but is opened to the public at large. A second round takes place if there is a Presidential veto of a law approved by the National Assembly, and there are further revisions to the law.[36] This process was followed for approval of many of the Prior Actions supported by this DPF, including those that are part of the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability.

86. **The World Bank is supporting the Government in the consultation and communication strategy related to the energy pricing and sectorial reforms.** The World Bank, through an Energy Sector Management Assistance Program (ESMAP)-financed activity, has supported consultation with 30 focal groups which represent different productive and household segments potentially affected by the reform. The output of these initial consultations will inform the preparation of a communication strategy and working sessions with different segments of society to discuss the timing and design of compensation mechanism associated with the reforms.

87. **Collaboration with other Development Partners.** This DPF is part of a package of coordinated financial assistance from international partners, including the IMF, IDB, and CAF. Staff of the four institutions have met regularly to coordinate efforts and align messages. There is no overlap of the specific measures supported in the DPF series with the structural benchmarks in the IMF, nor with prior actions included in the IDB and CAF operations. There are, however, strong complementarities in selected areas. These complementarities derive from coordinated technical assistance activities. For example, prior actions to improve human resource management build on the work under the Ecuador PFR and coordinate technical assistance with the IMF and IDB. The IMF assistance focuses on cutting personnel and containing wage growth, while the IDB supports the reorganization of personnel in MEF. On PFM, the DPF prior action related to strengthening budget processes creates conditions for implementation of a sound fiscal framework supported by the IMF. Support to the new PPP law, foreseen as a trigger for DPF 2, complements the IDB's program to support the implementation of PPPs and the sale of government assets. Annex 5 presents the different IFIs' support to the Government's reform agenda.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

88. **The Prior Actions supported by this operation are expected to have neutral or positive effects on poverty reduction in the short term and overall positive effects over the medium and longer term.** This assessment follows World Bank guidelines and provides an analysis of the potential distributional effects of the Government's program. It covers poverty and shared prosperity implications, as well as other welfare-related outcomes such as household income and expenditures, employment, and prices. The policies supported by this operation, such as the measures for increasing the efficiency in the

[36] A veto may happen when the President expresses concern or disagreement with aspects of a law after the first approval by the National Assembly. In this event, the law returns to the National Assembly and these aspects are revised.

mobilization and allocation of public resources, are expected to strengthen the Government's fiscal position. In addition, the Prior Actions aimed at removing barriers for private sector development are expected to facilitate private sector investment and develop and strengthen Ecuador's financial markets. Although not all of these policies and programs would have direct effects on poverty and inequality, their overall impact on welfare is estimated to be neutral or positive. Finally, the policies for protecting and including vulnerable populations are not expected to have significant impacts on the welfare of the less well-off in the short-run. However, these measures establish the bases for a proper functioning of a social protection system, economic opportunities for women and financial inclusion of the bottom of the distribution. The expected effects are based on quantitative analysis, the review of academic literature, and additional information gathered during the preparation of the operation.

89. **The Prior Actions under Pillar 1 are expected to have neutral or moderately positive distributional effects in the short run.** These policies are expected to strengthen the Government's fiscal position, enhance its budget preparation and procurement processes and are expected to have no or positive impacts on the bottom of the distribution. For instance, improvements in budget execution based on a proper budget formulation that addresses well-targeted pro-poor goals would positively impact poor and vulnerable populations in the medium-term as well as the enhance access to public goods and services for alleviating the poor's deprivations.

90. **The implementation of reforms to the energy sector subsidy scheme is expected to have no impacts on poverty/social outcomes in the short-run.** The removal of the subsidy scheme for two types of gasoline (i.e., super and extra) created fiscal space and helped balance the Government's budgetary position with negligible impacts at the bottom of the income distribution. Moreover, the improvement of the targeting in electricity subsidies would not produce any poverty or social impacts in the short-run. However, the removal of remaining subsidies will demand a proper compensation mechanism to prevent negative social consequences.

91. **The policies in Pillar 2 – aimed at removing barriers for private sector development – are expected to facilitate private sector investment and develop and strengthen financial markets.** Policy Actions related to trade facilitation that would reduce time and costs associated with international commerce are not expected to impact significantly the prices or quantities of imported goods. Policies to promote attraction and retention of foreign direct investment are expected to impact positively poverty reduction through expanding demand for labor. Other positive indirect effects might take years to materialize. Policies aimed at fostering FDI and local entrepreneurial activities could have positive impacts in the medium to long run working mainly through improving labor markets (formalization) and income generation opportunities (entrepreneurship), although the magnitude might not be substantial. Finally, policies to strengthen financial markets might have neutral to positive impacts by providing additional financing to segments that are currently penalized by the existing distortions in the systems such as risky borrowers and small and medium enterprises.

92. **Policies under Pillar 3 aim to protect and include vulnerable segments of the population and are not expected to have significant direct effects on the distribution of incomes in the short run.** The increase in scope for the Social Registry is necessary for the proper functioning of the social protection

system, as well as to identify the vulnerable population affected by the removal of the energy subsidies. In the short run, these policies will have a neutral effect on poverty or social outcomes. However, in the medium term when key instruments for improving the focalization of social programs will be in place, significant impacts on reducing extreme poverty will come to the fore. The Law on Prevention and Eradication of Violence Against Women, once fully implemented, can be an important instrument for women's empowerment, including economic empowerment.

93. **As the Government implements the reform agenda supported by DPF 2, positive social impacts are expected, with positive implications for gender equality.** This is particularly true for Indicative Triggers under Pillar 3. Labor income is the main component of total household income (i.e., about 80 percent in the last decade) and it was the main contributor to poverty reduction in the past. Before the fall in the international oil prices, almost 11 percentage points in poverty reduction could be attributed to improvements in labor income. Only about 70 percent of total household labor income comes from the household head. Thus, promoting access to more and better jobs for disadvantaged groups, like women and youth, could help to address equal opportunity goals. Most importantly, it could also boost households' welfare. On the other hand, similar results are expected in the medium run in the case of improving financial inclusion of women and vulnerable groups through strengthening cooperatives. Finally, the compensation mechanisms, with availability of payment systems, will be required to mitigate the potential negative impacts of the ongoing fiscal consolidation.

5.2. ENVIRONMENTAL ASPECTS

94. **The policies supported by the proposed DPF are not expected to have negative impacts on the country's environment or its natural resource base.** Prior Actions #1, #2, and #5 through #9 are not expected to cause significant impacts on Ecuador's environment or natural resource base.

95. **Two Prior Actions are expected to result in overall positive effects on Ecuador's environment and natural resource base.** Prior Action #3, which eliminates subsidies for premium gasoline, is expected to lead to lower consumption of those fuels by incentivizing more efficient use. The Government has raised the prices at the pump for all types of gasoline, such that any substitution effects should be minimal. Since the Government held constant the price of diesel at the pump, there could be a limited incentive for fuel switching to diesel in the automotive sector, which could lead to reduced greenhouse gas emissions but increased emissions of particulate matter. However, this effect is expected to be limited and would only manifest itself over the medium term, if diesel prices remains constant (or relatively lower) in the upcoming years. Currently, the great majority of private cars in use and produced run on gasoline and there is inertia of the automotive capital stock. The elimination of the subsidy for diesel used for industrial purposes is not expected to lead to adverse impacts given that it was accompanied by price liberalization of other fuels, including heavy fuel oils.

96. **Prior Action #4 is expected to reduce distortions in electricity pricing, providing incentives for reducing consumption through three mechanisms.** These include: (i) removing leakages in the social tariff

to prevent double dipping from those already benefiting from pricing in the bottom block of electricity tariffs; (ii) eliminating subsidies for off-peak industrial electricity tariffs, and (iii) the introduction of effective pricing discipline by reducing non-payment and arrears. The combined effect of measures (i) and (iii) is predicted to be a decrease in greenhouse gas emissions, contributing to Ecuador's climate change agenda, and leading to potential decreases in air pollution where oil-fired thermal electric plants are operating, with related benefits for air quality. On the other hand, measure (ii), by increasing the relative attractiveness of consuming electricity during peak demand hours, could result in a higher demand for baseline electricity production and associated provision of power generation capacity. However, differentiated market pricing for peak/off-peak hours is already in place and should mitigate this effect.

97. **Ecuador's legal and regulatory environmental management framework, underpinned by an environmentally progressive constitution, is relatively solid and complete, but its application is imperfect.** It includes a variety of instruments that regulate environmental issues and non-renewable natural resources. The 2017 Organic Environmental Code decentralizes environmental management and includes provisions such as the polluter pays principle and the principle of in *dubio pro natura*. It is complemented by laws and regulations regulating water, soil, and air quality, and by environmental provisions in sectoral laws, such as for hydrocarbons and mining. However, the implementation of such framework is suboptimal. Hampered by the lack of an environmental policy that recognizes current institutional weaknesses and orients the country toward specific goals based on clear priorities, it also suffers from shortcomings in human, material, and technical resources for enforcement. Finally, enforcement could be more effective if entrusted to an autonomous enforcement agency with attendant technical resources, in line with best practices.[37]

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

98. **The overall fiduciary weaknesses arise from Ecuador's public financial management (PFM) system, the use of budget resources, and its foreign exchange environment, as controlled by the Central Bank of Ecuador**. Key challenges include the weakened internal controls over the foreign exchange environment, the need for greater control over budget execution and cash payments, and the need for strengthened external scrutiny of public expenditures. Based on these attributes, the World Bank has identified some mitigating measures to contain fiduciary risks, should they arise during implementation such as audit of government transactions to ensure that funds are credit into the single treasury account. In addition, to support the Government in addressing some of these deficiencies, the DPF is proposing Prior Actions aimed at improving fiscal discipline by increasing the consistency between macro-fiscal programming and budget preparation, and more systematic budget control, during execution.

99. **Public Financial Management (PFM).** The most recent Public Expenditure and Accountability Assessment (PEFA), covering the years 2015 to 2017, is in final stages of completion. Early findings point to the need for implementing reforms aimed at: (i) strengthening the Government's capability to support

[37] World Bank (2019): Analysis of the Environmental Management System of the Republic of Ecuador. Unpublished Background Paper.

sustainable economic growth; (ii) maintaining aggregate fiscal discipline; (iii) fostering the strategic allocation of resources, and (iv) improving budget preparation and control. Taken together, these measures are essential to efficient delivery of public goods and services. PFM in Ecuador has its foundations in several interconnected systems and procedures, supported by a comprehensive regulatory framework and human resources and information technology tools. With the enactment in October 2010 of the Organic Code of Planning and Public Finances (*Codigo Organico de Planeacion de las Finanzas Publicas*), the country intended to modernize the complete cycle of public finances, covering inter alia implementation of a single treasury account, modernized government accounting, streamlined budget preparation and approval and improved fiscal transparency, and internal control. Nevertheless, the liquidity constraints and the abrupt decrease in fiscal revenue experienced from 2014 onwards, exposed several failures in the PFM system, such as poor coordination between key actors in the budget preparation and oversight, and the inability to maintain a fiscal discipline. Furthermore, according to the Open Budget Survey 2017, Ecuador ranks 49 out of 100 countries, and it is also ranked behind most of the countries in the Latin America region (10th place out of 15 countries)[38].

100. **Budget credibility and transparency.** As highlighted in the PFR[39], Ecuador's legal framework[40] defines the timetable for budget preparation and approval, along with other key content requirements. It also requires all public-sector entities to prepare their budget in accordance with the National Development Plan, based on multi-year projections for the next four years on a rolling annual basis, based on economic and functional classifications. Nevertheless, the fiscal regulatory and reporting mechanisms are only applied to the General Budget of the State (*Presupuesto General del Estado),* which excludes subnational entities, SOEs, social protection entities and financial public sector entities. Moreover, while the legal framework establishes policies aimed at reflecting country's priorities in the General Budget of the State, poor coordination between the entity in charge of planning process and definition of investment priorities, SENPLADES and MEF has led to a weak planning process under which budget projections have failed to include reliable macroeconomic forecasts. There are no established budget ceilings prior to the preparation of the budget proforma. The MEF is required to submit the budget for the approval of the National Assembly 60 days before the end of the calendar year. The National Assembly has 30 days after receiving the budget to approve it and the Government has generally adhered to these deadlines. The approved budget is made publicly available on line.

101. **Predictability and control in budget execution**. Budget monitoring mechanisms are embedded in the e-Sigef financial management information system. In-year fiscal reports are published monthly and are available for public access at the internet site of the MEF. Moreover, budget implementation reports are presented to the National Assembly every six months. At the budget execution phase, and to avoid

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[38] The main weaknesses include: i) failure to produce a pre-budget statement and publish the mid-year review on a timely manner; ii) need to improve the oversight by the legislature on the budget approval process including pre-budget debates and prior approval before implementing a supplemental budget, iii) need to improve participation by establishing credible and effective mechanisms for capturing a range of public perspectives on budget matters.
[39] Phase I dated in July 2018.
[40] As stated in the Political Constitution of Ecuador, the General Budget of the State (Circular 2017-2020), the Organic Code for Planning and Public Finances (Código Orgánico de Planificación y Finanzas Públicas) and its secondary rules (Reglamento del Código Orgánico de Planificación y Finanzas Públicas).

liquidity constrains, MEF has established additional layers of control over payments related to some expenditure categories (mainly fixed assets and transfers) which adds up to the existing figure of budget certificates established by the Budgetary Law. There is room to improve control of processes over cash payments by exercising a centralized control of cash payments. Furthermore, the budget is subject to numerous in-year adjustments mainly due to fiscal constraints and weak planning capability at the ministerial level. Line ministries and other entities part of the budgetary government have a discretionary limit to approve 15 percent of budget excess without approval of the National Assembly. This flexibility has resulted in an excessive number of in-year adjustments (up to 4,000 per year) [41], reflecting a poor level of control. The DPF is proposing a Prior Action aimed at eliminating the need for this substantial budget administrative revisions.

102. Government accounting in Ecuador is prepared on an accrual basis covering the institutions included in the general budget. Financial Statements are updated on a quarterly basis and published on the MEF's internet web page. Nevertheless, public sector accounting departs from international accounting standards[42]. Following a strong tendency in the public sector worldwide, Ecuador is pursuing convergence to International Public Sector Accounting Standards (IPSAS) and has put a comprehensive plan in place to that end. Nonetheless, the implementation progress of such plan is weak (10 percent[43] as of 2014 and 21 percent as of 2017[44]). The Government's initial goal was to produce financial statements in accordance with IPSAS by the year 2020. Although this objective seems quite ambitious and possibly unrealistic, the MEF is accompanying such reform with other key improvements such as an IPSAS certification for all MEF officials and updating the Integrated Financial Management Information System (IFMIS) e-Sigef[45]/SAP, which has finalized the design phase and has proceeded to the construction phase. It is expected all IFMIS modules will be ready and working for the beginning of CY 2020.

103. **External scrutiny of public expenditures*.*** The country's normative framework establishes the obligation to present the Government's financial statements to the country's the Supreme Audit Institution, *Contraloria General del Estado* or *CGE*. Nevertheless, there is no specific date requirement for this presentation, and the CGE has no obligation whatsoever to issue an opinion on the financial statements. The information regarding year 2017 was presented to the CGE in July 2018.

104. **Foreign exchange management.** Ecuador's official currency is the US dollar, so there is no foreign exchange risk. However, the Central Bank of Ecuador's legal framework does not provide sound safeguards for independent management of the central bank's resources, including reserve assets. The bank lacks autonomy and independence. The overall internal control environment presents several weaknesses due

[41] The aggregate final actual expenditure deviated from budgeted expenditure by large amounts especially during year 2016, due to the emergency budget allocated as a result of the earthquake that struck Ecuador, and during 2017 due to the Presidential transition.

[42] The Organic Code of Planning and Public Finance (Código Orgánico de Planeación y Finanzas Públicas) mandate the use of national public accounting rules for all public-sector entities

[43] Government Accounting and Financial Reporting Reforms in Latin America, WB 2014.

[44] Estado de Adopción NICSP de BID – Agosto 2017

[45] The Public Sector Financial Management System, called e-SIGEF, is a tool that automates the areas of programming and formulation, budget, accounting, treasury, fixed assets, payroll, and is designed to provide information at different levels of the public sector.

to the lack of independent and capable oversight and control mechanisms. Moreover, its financial reporting framework is based on local accounting principles, which depart from International Financial Reporting Standards issued by the International Federation of Accountants.

105. **Disbursement arrangements.** The World Bank will make the single loan disbursement to a dedicated account that forms part of the country's official foreign exchange reserves at the Central Bank. The disbursement will be made upon the World Bank's assessment on satisfactory compliance of Prior Actions agreed and compliance with the adequacy of the Borrower's macroeconomic policy framework. Disbursement will not be linked to any specific purchases and no procurement requirements will be needed. Once the Loan is approved by the Board of Executive Directors and the Loan Agreement is declared effective, the World Bank will disburse the proceeds of the Loan into a dedicated deposit account in US dollars at the Central Bank. This foreign currency account is exclusively for disbursements from the World Bank loans accounts. Upon receipt of the Loan, the Borrower will promptly account for the receipt of the Loan in the country's budget management system, in an account used to finance budgeted expenditures. Transactions and balances will be fully incorporated into the Borrower's accounting records and financial statements *via* the integrated financial management system (e-sigef). If the proceeds of the Loan or any part thereof are used for ineligible purposes, as defined in the Loan Agreement, the World Bank will require the Borrower to promptly return such amount to the World Bank. The amount refunded shall be cancelled from the Loan.

106. **Auditing arrangements.** Through the MEF the Borrower will: (i) report, within 30 days from the date of receipt, the exact sum received into the account; (ii) ensure that all withdrawals from the dedicated account are for budgeted public expenditures, excepting military expenditures or other items on the World Bank's excluded expenditure list, and (iii) provide the World Bank with a written confirmation that the proceeds from the loan were credited to the Treasury Single Account and that disbursements from that account were for budgeted public expenditures. The World Bank will request an audit of the dedicated account to be conducted following terms of reference and by an auditor acceptable to the World Bank.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

107. **MEF will be the main coordinating agency for monitoring and evaluation among other participating ministries.** The Prior Actions detailed in this operation are the prime responsibility of the following ministries and agencies: MEF, Ministry of Energy, Ministry of Production, Investment, and Commerce, National Planning Agency (SENPLADES) Energy, Hydrocarbon Regulatory Agency (ARCH), and Electricity Regulatory Agency (ARCONEL), and the Office of the Presidency of Cabinet of Ministers (*Secretaria General de la Presidencia)*. MEF will be coordinate with other ministries on monitoring of the results indicators, which are based on publicly available information. The World Bank will monitor implementation of the DPF through regular supervision missions and the preparation of the DPF 2.

108. **The program outcomes will be monitored through the measurement of the progress toward the achievement of results indicators included in the policy and results matrix (Annex 1).** This measurement seeks to assess progress toward the implementation of the policy and institutional measures supported

by the proposed DPF series and will be evaluated following the disbursement of the first DPF. MEF will have the responsibility of presenting the information related to the reform implementation and progress made toward results on time upon request, and in a format satisfactory to the World Bank.

109. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns.

6. SUMMARY OF RISKS AND MITIGATION

110. **The overall risk rating of this operation is assessed as high**. The major risks to the operation's ability to achieve its development objectives include macroeconomic risks and institutional capacity for implementation and sustainability risks. In addition, political and governance, fiduciary, and stakeholder risks are considered substantial. If macroeconomic risks were to materialize, they would adversely affect the Government's ability to implement and sustain the reform efforts – especially if they trigger social discontent – and hence make the outcome of the development agenda support by this DPF series less successful. The political dynamics could also affect the Government's ability to mobilize parliamentary support to approve some of the reforms included in the program. The DPF program is designed to include flexibility for DPF 2 to be adjusted in case some of these risks materialize. Specific risks, along with mitigation measures, are discussed below.

111. **Political and governance risks are assessed as Substantial, despite the strong commitment of the Government with its reform agenda and arise from the complex political context.** With parliamentary and presidential elections planned for February 2021, pre-election politics are likely to intensify next year. However, the pace of structural reforms might be disrupted even before that. As discussed, the President's party does not hold a majority in parliament and some of the envisaged reforms might require parliament approval, particularly for the second DPF. While it is likely that parliamentarians and/or a new government will continue to emphasize macroeconomic prudence and structural reforms, they might disagree on how to do it. One mitigating mechanism is the broad commitment by all political groups to the IMF/WB/IDB/CAF-supported reform program and the macroeconomic framework. The Government has also intensified consultations and is developing communication strategies to explain the reforms to the broad public. The World Bank is supporting some of these consultation and communication strategies through the ESMAP Trust Fund as well as the restructured Risk Mitigation and Emergency Recovery Project (P157324).

112. **Macroeconomic risks are assessed as High and stem from weak external and internal conditions.** Externally, tightening global financial conditions could push up global interest rates, which will further complicate financial access to Ecuador. This might also trigger capital outflows, which in turn could cause domestic rollover risks to intensify. An additional external risk could be an appreciation of the US

dollar and/or a slowdown of the US economy, which might depress Ecuador's exports. Ecuador's economy is also vulnerable to oil price volatility. Finally, the Ecuadorian economy might be adversely affected by further socio-economic deterioration in Venezuela, as it might have to absorb part of any renewed outflow of Venezuelan migrants to neighboring countries. Internally, the response of the economy to reforms might take longer than envisaged, or negative internal shocks such as natural disasters, might derail the recovery. Close supervision and engagement through the IMF, World Bank, IDB and CAF-supported programs will help mitigate these risks.

113. **Institutional Capacity for Implementation and Sustainability risks are assessed as High.** While there is strong commitment from the Government around the proposed program, implementation capacity is low in several areas. To mitigate these risks the authorities have mobilized technical assistance, including from the World Bank Group, in almost all the reform areas supported by this operation. Some of the supported measures aimed at strengthening governance and accountability in institutions (Prior Actions #1, #2, #3, and #10). In a politically complex environment where institutional capacity is weak, the reforms could potentially be reversed in the medium term. Mitigation measures include: (i) the DPF program together with the IDB's budget support are supporting the Government's objective of developing Ecuador's energy potential through supply-side (SOE reform, and upstream/downstream competition), demand-side (better targeting of subsidies), and institutional modernization of ARCH and ARCONEL) measures; and (ii) the World Bank's overall policy dialogue is supported by and closely coordinated with the IMF and the IDB to avoid duplication and enhance synergies.

114. **The fiduciary risks are expected to be Substantial because Ecuador's PFM systems and Central Bank's management require significant modernization**. These risks arise from weakened internal controls over the foreign exchange environment, the need for greater control over budget execution and cash payments, and the need for strengthened external scrutiny of public expenditures. Based on these attributes, the World Bank has identified some mitigating measures to contain fiduciary risks, should they arise during implementation such as audit of government transactions to ensure that funds are credit into the single treasury account. Some risks are addressed frontally through the design of the operation, which supports improvement in Ecuador's PFM systems. Also, the IMF program includes important elements of the modernization of the central bank governance and systems.

115. **Stakeholder risks are assessed as Substantial**. The Government's initial focus group consultations on fuel tariff-related reforms suggest that there is significant misunderstanding about who are the winners and losers of these reforms and the way the Government expects to mitigate the impact on the poorest households. Taxation reforms might also generate strong opposition from vested interests. To mitigate social risks coming from fuel subsidy reforms, a parallel Social Safety Net Project (P167416) is supporting the strengthening of social protection mechanisms. The World Bank is also supporting consultations and communications of these reforms under an ESMAP Trust Fund. Similar support will be mobilized for tax reform through the PFR and technical assistance associated to the restructured Risk Mitigation and Emergency Recovery Project (P157324).

Table 6: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Substantial
2. Macroeconomic	High
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	High
6. Fiduciary	Substantial
7. Environment and Social	Moderate
8. Stakeholders	Substantial
9. Other	
Overall	High

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results		
Prior Actions under DPF 1	**Triggers for DPF 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 1: Promote a more efficient allocation and mobilization of government resources.				
Prior Action #1. The Borrower has adopted measures to strengthen its budget preparation process by: (i) establishing budget processes and milestones, including the preparation and sharing of fiscally consistent ceilings for all public institutions covered by the budget; (ii) strengthening MEF's role on budget forecasting and programming; and (iii) endorsing the Principles of the Coalition of Finance Ministers for Climate Action; as evidenced by the Ministerial Decree (*Acuerdo Ministerial*) No. 0037 dated April 17, 2019 and published in the Official Gazette (*Suplemento*) No 474 on April 24, 2019; and the Borrower's signed Membership to the Coalition of Finance Ministers for Climate Action dated April 9, 2019.	(Indicative) Trigger #1. The Borrower amended the Organic Code of Planning and Public Finance to introduce a medium-term fiscal framework, revised downwards the current margin of 15% for changes in the budget without consulting the national assembly, and created an integrated national and subnational public investment system.	Results Indicator #1: Difference between approved and actual budget	16.3% (2017)	10% (2021)
Prior Action #2. The Borrower has improved spending in goods and services by issuing a resolution that introduces a strategic approach to procurement, through expanding the use of framework agreements and competitive processes; as evidenced by Resolution No. RE-SERCOP-2019-000096 dated January 24, 2019, published in the Official Gazette No. 743 on January 30, 2019.	(Indicative) Trigger #2. The Borrower has made spending in personnel more efficient by issuing a presidential decree introducing changes to: (i) its salary structure, particularly the pay scales; and (ii) pay-for-performance system; and it has further improved spending in goods and services amending the Procurement Law to improve transparency and competition in public biddings.	Results Indicator #2: Spending in goods and services and personnel in the NFPS as a share of GDP	14.7% (2017)	13.8% (2021)

Prior Action #3.The Borrower has issued decrees and regulations to: (i) eliminate subsidies for premium gasoline, industrial diesel, and natural gas for commercial and industrial use and reduce subsides for other fuels; and (ii) strengthen the Regulatory Agency for Hydrocarbon's mandate/governance by granting this Agency the responsibility of setting final prices of fuel products; as evidenced by Executive Decree No. 619 dated December 21, 2018 published in the Official Gazette No. 394 on December 26, 2018 and Executive Decree No. 724 dated April 24, 2019 and published in the Official Gazette No. 475 on April25,2019, respectively.	(Indicative) Trigger #3. The Borrower has issued a decree ensuring the fiscal separation between the hydrocarbon sector SOEs and the General government accounts; The Borrower has amended the Organic Law of Public Service of Electric Energy to, inter alia, allow the inclusion of all costs as bases for tariff calculation.	Results Indicator #3: Energy subsidies as a share of oil revenues	38.3% (2017)	37.1% (2021)
Prior Action #4. The Borrower has reduced electricity subsidies by issuing regulations to: (i) improve targeting of social tariffs; (ii) eliminate subsides to off-peak electricity industrial tariffs; and (iii) enforce effective pricing discipline by reducing non-payment and arrears; as evidenced by ARCONEL Resolution No. 005/19 dated April 16, 2019, ARCONEL Resolution No. 006/19 dated April 16, 2019; and ARCONEL Resolution No. 043/18 dated November 6, 2018 and published in the Official Gazette No. 647 on November 27, 2018.				
	(Indicative) Trigger #4. The Borrower has reformed its tax structure to increase revenue collection and reduce distortions.	Results Indicator #4: Tax revenues[46] as a share of GDP	13.5% (2017)	14.9% (2020)
Pillar 2: Remove barriers for private sector development				

[46] Excluding social security contributions.

Prior Action #5. The Borrower has adopted provisions to require the inclusion of international arbitration clauses in large contracts; as evidenced by the Productive Law dated August 7, 2018 and published in the Official Gazette (*Suplemento*) No. 309 on August 21, 2018.	(Indicative) Trigger #5. The Borrower has amended the Fiscal Incentives Law to align it with best international practices on Public Private Partnerships to, among others, clarify at strategic level the roles and responsibilities of the different government agencies along the PPP project cycle and decision-making process.	Results Indicator #5: The number of new government contracts for amounts higher than US $50 million, including PPP contracts in the tender process, that allow for international arbitration.	0 (2017)	At least 3 (2021)
Prior Action #6. The Borrower has adopted measures to facilitate firm entry, by: (i) including provisions in the Productive Law to strengthen the Limited Liability Modality for firms; and (ii) eliminating the obligation for importers to prove compliance with national technical requirements prior to arrival, replacing it with posteriori risk-based control; as evidenced, respectively, by Article 46 of the Productive Law and Resolution of the *Comité de Comercio Exterior* No. 024-2018 dated November 27, 2018 and published in the Official Gazette No. 379 on November 30, 2018.	(Indicative) Trigger #6: The Borrower has enacted a Law and regulations introducing a simplified regime for registering a corporation.	Results Indicator #6: i) The number of new commercial companies registered, and ii) average days to import[47].	i) 8210 (2017) ii) 4.9 (2017)	i) 10800 (2021) ii) 4.3(2021)
Prior Action #7. The Borrower has reduced distortions on the banking sector by issuing regulations to: (i) eliminate new Central Bank investments in public financial institutions; and (ii) increase bank liquidity by considering allocations to the Liquidity Fund as part of the	(Indicative) Trigger #7: The Borrower has reduced financial distortions by i) reforming the governance and sources of funding of public banks, ii) partially liberalizing interest ceilings; and iii) reforming the Financial and Monetary Code to allow banks to have subsidiaries that	Results Indicator #7: i) co-movement[48] between interest rate ceilings and nominal interest rates charged by banks for ordinary consumption and ii) participation of second tier	i) 0 (2017) ii) 0 (2017)	i) >0.2 (2020) ii) 17% (2021)

[47] Including time for nationalization and customs procedures.

[48] Co-movements is proxied by the ratio between standard deviation of monthly interest rate ceiling and the standard deviation of the effective interest rate measured with monthly data over an 18-month period

amount required by the Domestic Liquidity Requirement; as evidenced by Resolution 500-2019-M published in the Official Gazette on March 1, 2019 and Certification of the Secretary of the *Junta de Politica y Regulacion Monetaria y Financiera* dated March 1, 2019 and Resolution No. 513-2019-M dated May 10, 2019.	foster capital market development.	financing in the new lending operations of public banks[49].		
Pillar 3: Protect and include vulnerable segments of the population				
Prior Action #8. The Borrower has: (i) expanded the objectives of the Social Registry; and (ii) approved the creation of a unit within MEF dedicated to the design of compensation mechanisms to mitigate the impact of subsidy reforms; as evidenced by Executive Decree No. 465, dated August 1, 2018 published in the Official Gazette (*Suplemento*) No. 306 on August 6, 2018 and and *Oficio* No. SENPLADES-SIP-2019-0306-OF from the Borrower's National Secretariat of Planning, dated April 26, 2019.	(Indicative) Trigger #8: The Borrower has implemented a compensation mechanism to mitigate for the impact of fuel subsidy (gas, diesel, and electricity) price reforms.	Results Indicator #8: Share of households in the bottom 40 percent of the consumption distribution receiving compensation mechanisms for the subsidy reforms.	0 (2017)	80% (2021)
Prior Action #9. The Borrower has enacted a new law and regulatory framework aiming at preventing and eradicating violence against women to, *inter alia,* improve their economic opportunities; as evidenced by the Borrower's Law (*Ley para Prevenir y Erradicar la Violencia contra las Mujeres*) dated January 23, 2018 , published in the Official Gazette No. 175 on February 5, 2008 and; Executive Decree No. 397, dated May 15, 2018 and published in the Official	(Indicative) Trigger #9: The Borrower has approved a labor reform aimed at reducing informality, particularly among vulnerable segments of the population such as women and youth.	Results Indicator #9: Approved regulatory framework of the reform.	No	Yes

[49] Measured as the average new lending of BanEcuador and National Financial Corporation (CFN) during the reference year

Gazette (*Suplemento*) No. 254 on June 04, 2018.				
Prior Action #10. The Borrower has mandated the auditing of CONAFIPS in terms of its capacity to reach vulnerable sectors of the population; as evidenced by CONAFIPS Resolution DG 0011-2019 dated March 29, 2019, and *Oficio* No. PR-SGPR-2019-1130-O by the office of the Presidency dated March 29, 2019.	(Indicative) Trigger #10: The Borrower has issued regulations strengthening the regulatory framework and supervision for cooperatives and enacted regulations to facilitate the development of an electronic payment system to which vulnerable sectors of the population may have access. This system would need to be connected to the payment system used by commercial banks, public banks and cooperatives.	Results Indicator #11: The number of debt card transactions associated to consumption	33 million	57 million

ANNEX 2: FUND RELATIONS ANNEX

IMF Executive Board Concludes 2019 Article IV Consultation with Ecuador

March 21, 2019

On March 11, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation *[1]* with Ecuador. At the same time, the Board approved a three-year Extended Arrangements under the Extended Fund Facility; a press release on this was issued separately.

The 2014 oil price decline exposed the underlying structural imbalances of Ecuador's economy, including the very high non-oil primary fiscal deficit and rising public debt. Following several quarters of economic contraction in 2015 and 2016, the economy returned to growth, with a rebound of 2.4 percent in 2017. Since then, however, growth has decelerated and is forecast to be 1.1 percent for 2018. An expansion in domestic demand has been met through a rise in imports, particularly following the removal of tariff safeguards. Cumulative inflation was negative for much of 2018 reflecting slow growth, the overvaluation of the real exchange rate, and broader imbalances in the economy.

The government lowered the non-oil primary deficit (including fuel subsidies) from 7.6 percent of GDP in 2016 to 5.3 percent of GDP deficit in 2018. The adjustment that took place in 2018 was largely a product of a reduction of capital spending and the temporary effects of a tax amnesty during the year.

The authorities plan to reduce the non-oil primary balance by 5 percent of GDP over the next three years. There are likely to be near-term costs to growth from the planned fiscal consolidation, but supply-side reforms are expected to improve growth prospects over the medium term. Inflation is likely to remain subdued throughout the next few years. This, alongside nominal wage restraint and improving productivity, should steadily erode the overvaluation of the real effective exchange rate, which will allow the maintenance of a current account surplus over the medium term. Fiscal consolidation will also enable a moderate build-up of reserves, from very low levels.

Executive Board Assessment [2]

Directors commended the authorities for their efforts to transform the economy and address Ecuador's complex macroeconomic and structural challenges. Directors welcomed the authorities' focus on strengthening the fiscal, financial, and institutional foundations, and emphasized that strong commitment to sound policies and reforms will be critical to reducing balance of payments vulnerabilities, consolidating macroeconomic stability, putting dollarization on a stronger footing, and fostering job creation and sustainable growth.

Directors welcomed the authorities' commitment to restore fiscal discipline and sustainability. They agreed that adjustment efforts should focus on a combination of expenditure and revenue measures. Directors saw need for a realignment of the public sector wage bill, careful reduction in untargeted subsidies, and reprioritization of capital and goods and services spending. They also emphasized the importance of making the tax system more equitable, growth friendly, and simpler. Directors acknowledged that while these fiscal efforts might impact growth in the near term, they are key to sustained and equitable growth over the medium term.

Directors welcomed the focus on lowering the debt to GDP ratio and complementing the existing expenditure growth rule with binding annual targets for the non-oil primary balance. They concurred that the publication of timely and periodic in year reports to assess compliance with fiscal rules would further strengthen credibility. Over time, better public financial management, budget procedures, and procurement practices, combined with more rigorous fiscal controls, would make fiscal policy more effective.

Directors welcomed the authorities' commitment to protect the poor and the most vulnerable. To manage the impact of the economic transition and maintain societal support for the economic program, Directors encouraged the authorities to move quickly to expand the eligibility of social assistance programs, with better targeting and a higher level of benefits. Over the longer term, they called for action to improve education and health outcomes.

Directors underscored the importance of supply side reforms in restoring competitiveness. A more efficient tax system, public wage restraint, enhanced access to the formal labor market through improved hiring processes, and better governance will all contribute to a vibrant, private sector led growth model. Directors emphasized that there remains scope to remove trade barriers, improve the business climate, and create opportunities for greater private sector involvement.

To support dollarization, Directors endorsed measures to build financial resilience, remove impediments to effective financial intermediation, and strengthen the central bank, including through building up international reserves. To better anticipate and adapt to shocks, Directors recommended increasing the oversight of banks and cooperatives and building crisis preparedness and contingency planning capabilities. Directors considered that simplifying the complex system of liquidity regulations and gradually phasing out interest rate ceilings would support greater access to financial intermediation. They commended the authorities' efforts to make the central bank more operationally independent, to strengthen its governance, and to restrict it from providing fiscal financing. Directors encouraged steps to strengthen the effectiveness of the AML/CFT framework.

Ecuador: Selected Economic Indicators

	2016	2017	Est. 2018	Proj. 2019	Proj. 2020
Output					
Real GDP growth	-1.2	2.4	1.1	-0.5	0.2
Employment					
Unemployment (%)	5.2	4.6	3.7	4.3	4.7
Prices					
Inflation, average (%)	1.7	0.4	-0.2	0.6	1.2
Public sector 1/					

Revenue (% GDP)	30.3	32.0	36.3	35.2	38.3
Expenditure (% GDP)	38.6	36.6	37.2	35.2	34.6
Overall balance (% GDP)	-8.2	-4.5	-0.9	0.0	3.8
Debt (% GDP)	43.2	44.6	46.1	49.2	46.8
Money and credit					
Broad money (% change)	16.5	10.0	5.6	1.7	4.2
Credit to the private sector (% change)	6.2	16.4	14.9	4.4	5.7
Balance of payments					
Current account (% GDP)	1.3	-0.4	-0.7	0.4	1.4
FDI (% GDP)	0.8	0.6	0.9	1.1	1.1
GIR (in months of imports)	2.7	1.1	1.0	2.5	3.9
External debt (% GDP)	36.6	39.5	40.5	42.8	42.9

Sources: Central Bank; Ministry of Finance; National Statistical Institute (INEC); and Fund staff estimates/projections. 1/ Consolidated at the level of the non-financial public sector.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: ***http://www.imf.org/external/np/sec/misc/qualifiers.htm*** .

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ANNEX 3: LETTER OF DEVELOPMENT POLICY

ECONOMIA Y FINANZAS

Quito, D.M., 29 de abril de 2019

Asunto: Ecuador: Préstamo Programático bajo la modalidad *Development Policy Loan* (DPL)

Señor
David Malpass
Presidente
BANCO MUNDIAL
WASHINGTON, D.C.

Estimado Sr. Malpass:

El Ecuador se encuentra en un momento histórico de transición. Estamos saliendo de un modelo poco sostenible hacia una economía más estable con crecimiento económico inclusivo que genere empleo y oportunidades para todos, en especial para los más desfavorecidos, donde el sector privado sea el motor del progreso.

Esta transición es desafiante en múltiples dimensiones. El Gobierno ecuatoriano está comprometido con corregir los problemas estructurales de la economía mediante una agenda de reformas económicas priorizando las barreras más importantes y urgentes para el desarrollo sostenible y compartido del Ecuador y velando por el bienestar de la población más vulnerable, con el fin de asegurar mejoramiento continuo de su calidad de vida.

Estamos avanzando con absoluta transparencia en esta agenda porque estamos convencidos que éste debe ser el signo de un Ecuador moderno que abandona prácticas del pasado reciente y se abre a la participación de la ciudadanía, en el marco de un programa integral por la prosperidad.

Es en este contexto que desde Agosto del 2018 estamos implementando un programa social y económico integral llamado *Plan de Prosperidad*. Los resultados favorables que ya hemos conseguido nos muestran que es el camino que el Ecuador necesita tomar en este punto de inflexión tan crítico.

El Plan de Prosperidad, enmarcado en los Objetivos de Desarrollo Sostenible, está compuesto por cuatro pilares fundamentales que van dirigidos a los principales desafíos que enfrenta la economía ecuatoriana: i) reconstruir y fortalecer los cimientos institucionales de la dolarización; ii) generar empleo y crecimiento a través de mayor competitividad; iii) promover igualdad de oportunidades y proteger a los pobres y vulnerables; y iv) garantizar un clima de transparencia y buen gobierno.

La caída de los precios del petróleo reflejó la falta de responsabilidad en la administración de la bonanza, y las vulnerabilidades macroeconómicas y estructurales de una economía sustentada en el gasto del gobierno. Adicionalmente, recientes análisis en educación y salud muestran que si bien hubo avances significativos en acceso y cobertura de servicios, la agenda de calidad y eficiencia en el gasto tiene espacios de mejora. En generación de empleo en el sector privado hay tareas pendientes y urgentes. Debemos mejorar la situación fiscal hacia la sostenibilidad, impulsar inversión privada, generar oportunidades para todos los ciudadanos y salvaguardar los logros sociales. A todos estos retos, se suma el influjo de refugiados producto de la crisis que vive actualmente Venezuela. La atención a la población venezolana que llega al Ecuador en busca de paz y mejores oportunidades implica para el Ecuador una presión fiscal adicional y significativa.

Debido a la dolarización, el Gobierno cuenta con limitadas opciones de política económica para corregir los desequilibrios macroeconómicos. Adicionalmente, el país enfrenta acceso limitado a fuentes de financiamiento interno y altos costos en los mercados internacionales de capital que impiden implementar políticas anticíclicas para estabilizar la economía. A esto se suma la poca capacidad del sector privado para compensar la disminución de la inversión pública en el corto plazo. Como resultado, el crecimiento económico se ve afectado y las tendencias en reducción de la pobreza y empleo también.

El Gobierno ya ha realizado esfuerzos importantes para afrontar los problemas fiscales e incentivar la inversión. El déficit del sector público no financiero se redujo del -8,2 por ciento del PIB en el 2016 a -0,9 por ciento en el 2018. En agosto de 2018, se publicó la Ley de Fomento Productivo que introduce reglas macro fiscales para el manejo de las finanzas públicas, junto con incentivos para acelerar la inversión privada, dentro de los que se encuentran exenciones tributarias para nuevas inversiones en todos los sectores de la economía, restablecimiento de la responsabilidad limitada de las empresas, garantías para que las empresas accedan a mecanismos de arbitraje internacional de acuerdo con el marco constitucional, entre otras.

Sin apoyo multilateral, sería muy difícil avanzar en la agenda de reformas. El Plan de Prosperidad está recibiendo el apoyo necesario de la comunidad internacional. Uno de los aliados clave es el Banco Mundial, con quien hemos identificado una serie de reformas ya contempladas en nuestro plan, las que serían apoyadas mediante un programa del Banco Internacional de Reconstrucción y Fomento (BIRF) bajo la modalidad *Development Policy Loan*. Este programa complementaría el reciente acuerdo con el Fondo Monetario Internacional (FMI) en el marco del Servicio Ampliado del FMI (SAF) por un monto de USD 4.200 millones, el mayor aporte financiero que ha recibido el país por parte de esta institución.

El préstamo que han preparado los equipos técnicos tiene los siguientes tres ejes: (i) consolidación fiscal; (ii) competitividad y atracción de inversiones; y (iii) protección e inclusión social. A continuación, me permito detallar las políticas que hacen parte del programa y que están enmarcadas en el Plan de Prosperidad. Estas políticas corresponden a una agenda de largo

aliento que también se detalla en el Memorandum de Políticas que acompaña el acuerdo con el FMI.

En el campo fiscal, las reformas promueven el uso y asignación eficiente de los recursos públicos, apoyadas en una consolidación fiscal ordenada que mejora los procesos presupuestarios, permite un manejo más eficiente del gasto público y genera mayores ingresos dentro de un marco de trasparencia de la gestión gubernamental. Para esto, es necesario contar con un conjunto de políticas que optimicen y transparenten el proceso de preparación del presupuesto, optimicen los procesos de compras públicas y gestión del recurso humano, cambien la fijación de precios de los productos energéticos, focalicen los subsidios hacia los grupos más vulnerables y eliminen ineficiencias en la política tributaria.

El programa incluye tres pasos importantes en esta dirección: i) nueva reglamentación para la preparación del presupuesto basada en estándares internacionales, fortalecimiento del rol del Ministerio de Economía en la elaboración y supervisión del presupuesto, estableciendo límites de gasto por institución; (ii) firma de los principios de Helsinki para alinear la política fiscal con objetivos climáticos; (iii) expedición del Decreto 619 que elimina los subsidios a la gasolina premium y el diésel industrial; además, la Agencia de Regulación y Control Hidrocarburífero sería la institución responsable de establecer los precios finales de los combustibles; y, iii) implementación de nuevas regulaciones para mejorar los procesos de compras públicas mediante la introducción de un enfoque estratégico para las adquisiciones que amplíe el uso de acuerdos marco y procesos competitivos. Cabe mencionar que la focalización de los subsidios energéticos es una política con un claro eje social y ambiental, que esperamos ayude a reducir emisiones y mejorar la calidad de los combustibles.

Adicionalmente, el Gobierno está trabajando en una reforma tributaria encaminada a reducir distorsiones (ej. exenciones de impuestos y deducciones de gastos personales) y con ello incrementar la recaudación tributaria, así como, un sistema que mejore la focalización de los subsidios a la electricidad a los grupos más vulnerables y racionalizar los subsidios a las tarifas industriales fuera de las horas pico.

Con respecto a la generación de empleo y reactivación productiva, el Gobierno reconoce la necesidad de simplificar la actividad privada mediante la eliminación de barreras no arancelarias, reducción de obstáculos regulatorios para abrir y cerrar empresas, mejora de eficiencias y aumento de la competencia en el sector financiero mediante reformas a los requisitos mínimos de liquidez y a los topes a las tasas de interés para facilitar la disponibilidad de financiamiento para la inversión privada, reincorporación de los contratos de participación en producción petrolera y de mecanismos de solución de controversias para inversiones extrajeras, un marco institucional eficiente basado en estándares internacionales para el desarrollo de las Alianzas Público-Privadas y una optimización de la gobernanza de los bancos públicos.

Cabe destacar que el Gobierno ha avanzado en esta dirección con la elaboración e implementación reglamentaria de la Ley Orgánica para el Fomento Productivo, Atracción de

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Inversiones, Generación de Empleo, y Estabilidad y Equilibrio Fiscal. Este marco legal establece acciones concretas de política, entre las que se encuentran el arbitraje internacional para grandes contratos de inversión y disposiciones que fortalecen el principio de responsabilidad limitada para las empresas. Una de las medidas adicionales es la firma de un memorando de entendimiento no exclusivo con el centro de arbitraje de Chile, ya que cuenta con las prácticas de transparencia más altas en arbitraje internacional, dando así mayor seguridad a inversionistas. Otras acciones de política que están siendo implementadas por el Gobierno bajo este pilar incluyen regulaciones que eliminan nuevas inversiones del Banco Central en bancos públicos, incrementan el acceso a la liquidez en el sistema bancario para la colocación de créditos y mejoran el proceso de control de los requisitos técnicos nacionales para los importadores.

En lo referente a protección social a los segmentos vulnerables de la población como el aspecto más importante de nuestra política pública, el Gobierno reconoce que el proceso de consolidación fiscal no puede afectar a la población más vulnerable. Es nuestra prioridad garantizar el mejoramiento continuo de la calidad de vida de nuestros ciudadanos más desfavorecidos. Estamos incrementando los recursos destinados a una red de seguridad bien orientada, eficiente y sostenible para proteger y mejorar las ganancias sociales alcanzadas en las últimas décadas. El primer paso para cumplir con este objetivo es mejorar el sistema de información y procesos de selección de beneficiarios de programas sociales, y promover una gestión más eficiente de los mismos. Entre las acciones de políticas está el fortalecimiento del sistema de información de beneficiarios (Registro Social), la creación de un equipo dentro del Ministerio de Economía dedicado al diseño de mecanismos de compensación para mitigar el impacto de las reformas de los subsidios.

Estamos comprometidos con la inclusión financiera. Las cooperativas, por su nivel de penetración, son consideradas como un eje prioritario dentro de ese pilar. La transparencia y eficiencia de este sector es un mecanismo para promover la inclusión financiera de los sectores vulnerables de la población. Se ha dispuesto una auditoría a la Corporación Nacional de Finanzas Populares y Solidarias con la finalidad de evaluar la capacidad de esta institución para destinar recursos para inversiones productivas a través del sistema de cooperativas a los sectores vulnerables de la población.

Dentro del mismo pilar social, consideramos como eje prioritario en este programa la igualdad de género, y vemos la oportunidad de promover aún más la participación laboral por parte de la mujer, facilitando el acceso a empleos temporales o a tiempo parcial. La legislación aprobada en contra de la violencia de género es una muestra más de nuestro compromiso en esta área.

El crédito bajo la modalidad *Development Policy Loan* será implementado a través de una primera operación con un desembolso de quinientos millones de dólares estadounidenses (USD 500.000.000) una vez que se verifiquen la implementación de las acciones que nos hemos propuesto en el marco del Plan de Prosperidad. Al efecto, el ejecutor del programa será el Ministerio de Economía y Finanzas, en coordinación con las entidades y ministerios relevantes.

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El Banco Mundial es un aliado estratégico para la implementación exitosa de las reformas que harán que la transición hacia una economía estable, próspera, inclusiva y sostenible sea viable. El conocimiento, experiencia y apoyo del Banco a nivel mundial son un soporte clave en hacer esto posible.

Agradeciendo su atención, reciba un cordial saludo.

Atentamente,

Sr. Richard Iván Martínez Alvarado
Ministro de Economía y Finanzas
GOBIERNO DEL ECUADOR

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Letter of Development Policy (English Translation)

Quito, D.M., April 29, 2019

Subject: Ecuador Programmatic Development Policy Loan (DPL)

Sir
David Malpass
President
WORLD BANK
WASHINGTON, D.C.

Dear Mr. Malpass:

Ecuador is at a historic moment of transition. We are emerging from an unsustainable model towards a more stable economy with inclusive economic growth that generates employment and opportunities for all, especially for the most disadvantaged, where the private sector is the engine of progress.

This transition is challenging in many dimensions. The Ecuadorian Government is committed to correcting the structural problems of the economy through an economic reform agenda that prioritizes the most important and urgent barriers to the sustainable and shared development of Ecuador and safeguards the welfare of the most vulnerable population, in a way that ensures continuous improvement of their quality of life.

We are advancing with absolute transparency in this agenda because we are convinced that this must be the sign of a modern Ecuador that abandons practices of the recent past and opens up to the participation of citizens, within the framework of a broad program to promote prosperity.

It is in this context that since August 2018 we are implementing a comprehensive economic and social program called the Prosperity Plan. The favorable results that we have already achieved show us that this this is the right path for Ecuador at this critical turning point.

The Prosperity Plan, framed within the Sustainable Development Goals, is composed of four fundamental pillars that are aimed at the main challenges facing the Ecuadorian economy: i) reconstructing and strengthening the institutional foundations of the dollarization; ii) generating employment and growth through greater competitiveness; iii) promoting equal opportunities and protecting the poor and vulnerable; and iv) guaranteeing a climate of transparency and good governance.

The drop in international oil prices revealed the lack of responsibility in the administration of the public resources, and the macroeconomic and structural vulnerabilities of an economy sustained by government spending. Additionally, recent analyzes in education and health show that although there were significant advances in access and coverage of services, there is room for improving on the quality

of services and efficiency of spending. There are pending and urgent tasks with respect to generation of employment in the private sector. We must improve the fiscal situation towards sustainability, boost private investment, generate opportunities for all citizens and safeguard social achievements. The influx of refugees due to the current crisis in Venezuela adds to all these challenges. The attention to the Venezuelan population that arrives in Ecuador in search of peace and better opportunities implies an additional and significant fiscal pressure for Ecuador.

Due to the dollarization regime, the government has limited economic policy tools to correct macroeconomic imbalances. Additionally, the country faces limited sources of domestic financing and high costs of financing in international capital markets, which impede the implementation of countercyclical policies to stabilize the economy. The limited capacity of the private sector to compensate for the decrease in public investment in the short term add to these challenges. As a result, economic growth is affected and trends in poverty reduction and employment as well.

The Government has already made important efforts to address fiscal problems and encourage investment. The deficit of the non-financial public sector was reduced from 8.2 percent of GDP in 2016 to 0.9 percent in 2018. In August 2018, the Law on Productive Development was published, introducing macro-fiscal rules for the management of public finances, together with incentives to accelerate private investment, including tax exemptions for new investments in all sectors of the economy, reinstatement of limited liability of companies, guarantees for companies to access to international arbitration mechanisms in accordance with the constitutional framework, among others.

Without the support of multilateral organizations, it would be very difficult to move forward on the reform agenda. The Prosperity Plan is receiving the necessary support from the international community. The World Bank is a key ally with whom we have identified a series of reforms already contemplated in our plan, which would be supported through a program supported by the International Bank for Reconstruction and Development (IBRD) under a Development Policy Loan. This program would complement the recent agreement with the International Monetary Fund (IMF) within the framework of the Extended Fund Facility (EFF) for an amount of USD 4,200 million, the largest financial contribution that the country has received from this institution.

The loan prepared by the technical teams has the following three axes: (i) fiscal consolidation; (ii) competitiveness and private investment attraction; and (iii) social protection and inclusion. Next, I present the policies that are part of the program and that are framed in the Prosperity Plan. These policies correspond to a long-term agenda that is also presented in the Policy Memorandum that accompanies the agreement with the IMF.

In the fiscal ax, the reforms promote the efficient use and allocation of public resources, supported by an orderly fiscal consolidation that improves budgetary processes, allows a more efficient management of public spending and generates higher revenues within a framework transparent government management. For this, it is necessary to have a set of policies that optimize and increase transparency of the budget preparation process, optimize public procurement processes, improve the management of human resources, change the pricing of energy products, focus subsidies on groups more vulnerable and eliminate inefficiencies in tax policy.

The program includes three important steps in this direction: i) new regulations for the preparation of the budget based on international standards, strengthening the role of the Ministry of Economy in the preparation and supervision of the budget, establishing spending ceilings by institution; (ii) signature of the Helsinki principles to align fiscal policy with climate objectives; (iii) issuance of Decree 619 that eliminates subsidies for premium gasoline and industrial diesel; in addition, the Hydrocarbons Regulation and Control Agency would be the institution responsible for establishing the final prices of fuels; and, iii) implementation of new regulations to improve public procurement processes by introducing a strategic approach to acquisitions that broadens the use of framework agreements and competitive processes. It is worth mentioning that the targeting of energy subsidies is a policy with a clear social and environmental axis, which we hope will help reduce emissions and improve the quality of fuels.

In addition, the Government is working on a tax reform aimed at reducing distortions (eg, tax exemptions and deductions for personal expenses) and thereby increasing tax collection, as well as a system that improves the targeting of electricity subsidies to the most vulnerable groups and rationalize subsidies to industrial tariffs outside peak hours.

Regarding job creation and productive reactivation, the Government recognizes the need to simplify private activity by eliminating non-tariff barriers, reducing regulatory obstacles to open and close companies, improving efficiencies and increasing competition in the sector. financial system through reforms to minimum liquidity requirements and interest rate ceilings to facilitate the availability of financing for private investment, reincorporation of oil production participation contracts and dispute resolution mechanisms for foreign investment, a framework efficient institutional based on international standards for the development of Public-Private Partnerships and an optimization of the governance of public banks.

It should be noted that the Government has made progress in this direction with the preparation and enactment of the Organic Law for Productive Development, Attraction of Investments, Employment Generation, and Fiscal Stability and Balance. This legal framework establishes concrete policy actions, among which are international arbitration for large investment contracts and provisions that strengthen the principle of limited liability for companies. One of the additional measures is the signing of a non-exclusive memorandum of understanding with the Chilean arbitration center, since it has the highest transparency practices in international arbitration, thus giving greater security to investors. Other policy actions that are being implemented by the Government under this pillar include regulations that eliminate new Central Bank investments in public banks, increase access to liquidity in the banking system for loan placement, and streamline the national technical requirements for importers.

Regarding social protection to the vulnerable segments of the population as the most important aspect of our public policy, the Government recognizes that the process of fiscal consolidation cannot affect the most vulnerable population. It is our priority to guarantee the continuous improvement of the quality of life of our most disadvantaged citizens. We are increasing the resources allocated to a well-oriented, efficient and sustainable safety net to protect and improve the social gains achieved in recent decades. The first step to fulfill this objective is to improve the information system and selection processes for beneficiaries of social programs and promote a more efficient management of them. Among the policy actions is the strengthening of the beneficiary information system (Social Registry), the creation of a

team within the Ministry of Economy dedicated to the design of compensation mechanisms to mitigate the impact of subsidy reforms.

We are also committed to financial inclusion. Cooperatives, due to their level of penetration, are considered as a priority axis within that pillar. The transparency and efficiency of this sector is a mechanism to promote the financial inclusion of vulnerable sectors of the population. An audit has been made available to the National Popular and Solidarity Finance Corporation in order to evaluate the capacity of this institution to allocate resources for productive investments through the cooperative system to vulnerable sectors of the population.

Within the same social pillar, we consider gender equality as a priority axis in this program, and we see the opportunity to further promote labor participation by women, facilitating access to temporary or part-time jobs. The legislation passed against gender violence is another example of our commitment in this area.

The credit under the Development Policy Loan modality will be implemented through a first operation with a disbursement of five hundred million US dollars (USD 500,000,000) once the implementation of the actions we have proposed under the Plan is verified. of Prosperity. To this end, the executing agency of the program will be the Ministry of Economy and Finance, in coordination with the relevant entities and ministries.

The World Bank is a strategic ally for the successful implementation of the reforms that will make the transition to a stable, prosperous, inclusive and sustainable economy viable. The knowledge, experience and support of the Bank worldwide are a key support in making this possible.

Thank you for your attention, receive a cordial greeting.

Sincerely,

Mr. Richard Iván Martínez Alvarado
Minister of Economy and Finance
GOVERNMENT OF ECUADOR

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1: Promote a more efficient allocation and mobilization of government resources		
Prior action #1. Budget process and institution	No significant environmental effects expected	No distributional effects are expected in the short run. The improvement in budget control from MEF is not expected to have significant effects on poverty in the short run.
Prior action #2. Public Procurement	No significant environmental effects expected.	The improvement in governmental procurement processes would have positive impacts on the welfare of the poor. Improving access to public goods and services and their quality could alleviate poor's deprivations
Prior action #3 and # 4. Energy pricing	Positive effect expected by incentivizing more efficient fuel and electricity use.	The reduction in gasoline subsidies would not have significant impacts on the welfare of the bottom 40. The strengthening of the Regulatory Agency for Hydrocarbon would not produce any poverty nor social impacts in the short-term. However, large and negative impacts might happen on vulnerable populations if subsidies in Liquefied Petroleum Gas (LPG) and diesel are eliminated without implementing proper compensation measures. The improvement in the targeting electricity subsidies is not expected to generate welfare impacts at the bottom 40.
Pillar 2: Remove barriers for private sector development		
Prior action #5 International arbitration	No significant environmental effects expected.	Neutral impact on poverty reduction and shared prosperity in the short run. Positive distributional effects because of higher

		economic growth through increased foreign direct investment in the medium to long-run.
Prior action #6 Limited liability firms	No significant environmental effects expected.	No significant welfare effects in the short-run. Indirect positive impact on welfare in the medium-long-run through enhancing labor conditions (i.e., increase in formal employment) and might have positive gender impacts.
Prior action #7 Financial sector	No significant environmental effects expected.	No potential impacts in welfare in the short-run. Potential positive effects through increase in efficiency and effectiveness of public banks that would create financial inclusion. Although is not expected to have a significant direct impact on the poor in the short-run.
Pillar 3: Protect and include vulnerable segments of the population		
Prior action #9 Social Registry	No significant environmental effects expected.	No potential effects on welfare in the short-run. Expanding the scope and definition of the institutional framework of the Social Registry will set the bases for a well-functioning social protection system that would definitely improve the socioeconomic conditions of vulnerable populations.
Prior action #10 CONAFIPS	No significant environmental effects expected.	No adverse welfare effects in the short-run. Positive effects in the medium-term, mostly to financial inclusion of lower segments of the population by strengthening the regulatory framework and supervision of cooperatives.

POVERTY AND SOCIAL IMPACT ASSESSMENT (PSIA)[50]

PILLAR 1: INCREASE EFFICIENCY IN THE MOBILIZATION AND ALLOCATION OF PUBLIC RESOURCES

Prior Action 1: *The Borrower has adopted measures to strengthen its budget preparation process by: (i)*

[50] This PSIA has been prepared by Sergio Olivieri (GPV04), Leandro Chalela (GPV04), Ana Rivadeneira (GSURR) and Ivan Gachet (MTI)

establishing budget processes and milestones, including the preparation and sharing of fiscally consistent ceilings for all public institutions covered by the budget; (ii) strengthening MEF's role on budget forecasting and programming; and (iii) endorsing the Principles of the Coalition of Finance Ministers for Climate Action.

1. **The improvement in budget control from MEF is not expected to have significant effects on poverty in the short run.** This prior action aims to improve fiscal discipline by increasing the consistency between macro-fiscal programming and budget preparation. The regulatory reform focuses on regulatory changes that can be introduced by the executive and can have an immediate impact on the 2020 budget preparation cycle. The regulatory reform also reestablishes fiscally consistent aggregate ceilings and ceilings for budgetary institutions, that are properly shared with institutions at the beginning of the budget preparation cycle. Finally, the regulation simplifies budget forecasting and programming, strengthening the roles and responsibilities of MEF at this stage. In sum, all the above promotes better and clears budget ceilings, prioritization of spending, and budget planning. Evidence does not suggest that legislation, regulations and codes practices have a direct impact on "sufficient and timely funding for policy implementation" nor on "resource allocation better reflects policy". [51] However, the medium-term expenditure framework (MTEFs) shows positive effects in these outcomes as well in "planned and timely funding releases and budget processes."

2. **Nonetheless, we could expect some positive welfare impacts for the poor in the medium term if budget execution follows the improvement in budget formulation**. Extreme Poverty eradication can only be achieved with well-targeted, effective, efficient and sustainable pro-poor programs. To this end, sound budget management is essential to eliminate waste and rigidities and improve service delivery. The budget is both an instrument of economic management and an implicit policy statement, as it sets priorities and relative levels of spending for different programs and activities. Weaknesses in the budget processes and institutional bottlenecks could play a significant role in the poor performance of social programs and public policy in general. Eliminating these barriers is critical for improving budget execution and translating public priorities to outcomes. Budget control could enhance the quality of spending (i.e., targeting, efficiency, and effectiveness) and budget programming could insurance resource availability for prioritized government programs. Thus, this prior action could strengthen the public policy impact on the most vulnerable.

[51] See De Lay, S., Mills, L., Jadeja, K. & Lucas, B. (2015) Public Financial Management Evidence Mapping. Birmingham, UK: GSDRC, University of Birmingham.

Prior Action 2: *The Borrower has improved spending in goods and services by issuing a resolution that introduces a strategic approach to procurement, through expanding the use of framework agreements and competitive processes.*

3. **The improvement in governmental procurement processes would have positive impacts on the welfare of the poor.** The primary objective of this prior action is to increase transparency and competition of public contracts generating saving at the level of unit prices and standardizing good and services quality. Reforms in this system could speed up the availability of inputs, shortening procurement lead times, while ensuring minimum standards for quality and increasing the purchasing power of public resources. Evidence suggests that procurement reforms could generate significant savings. For instance, the Philippines government saved between 11 percent in vehicles and other supplies and 53 percent in drugs and various medicines by posting procurement opportunities on its electronic system.[52] Moreover, the Republic of Korea saves USD 2.5 billion per year by using an e-procurement system.[53] Similarly, the United Kingdom realized a 3.6 percent savings (equal to 3 billion pounds) on its procurement processes over a 3-year-period due to paying greater attention to complex procurement cases[54], and the health sector in Guatemala saved 43 percent in 1999 by dropping the use of biased technical specifications when buying medicines.[55] Also, the Philippines's procurement reform shows improvements on the volume of social assets procured in one World Bank-financed project. While the expected volume of textbooks based on pre-reform procurement practices was 25 million, the delivered volume after the reform was 42 million with 50 percent of price savings per unit. The same holds for classrooms and schools' desks and chairs.

4. **Improving access to public goods and services and their quality could alleviate some of the poor's deprivations**. A broader definition of poverty goes beyond the lack of command over commodities.[56] The lack of human, social, natural, physical and financial capital are part of the set of multiple deprivations poor and vulnerable populations also face. The public sector could help these populations overcome these types of deprivations by guaranteeing equal opportunities to public services access. The nation's public procurement system is a crucial element in helping to reduce these deprivations. For instance, the construction of schools, clinics, and roads, drilling of wells, and the acquisition of medicine and textbooks, happen mostly through the nation's public procurement system. Standardizing the quality of these goods and services is critical for strengthening human capital (i.e., improving education or nutritional levels) for the most vulnerable as well as reducing gap-goals such as access to water or sanitation in rural areas. Furthermore, given budgetary ceilings, this prior action would reduce unit prices per unit, increase or maintain quality and increase quantities procured. These improvements in procurement processes should be accompanied by a proper distribution mechanism which will guarantee positive effects on the welfare of the bottom 40.

[52] See World Bank and OECD, 2004. "Mainstreaming and strengthening public procurement: a strategic framework". Third Join Round Table on Strengthening Procurement Capacities in Developing Countries.
[53] The initial investment of the e-procurement system costs US$ 26 million. See World Bank, 2004. "Korea's Move to e-Procurement". PREM Notes No. 90.
[54] See "Improving Procurement: Progress by the Office of Government Commerce in improving departments' capability to procure cost-effectively." Report of the National Audit Office of the U.K. March 2004.
[55] See OECD, 2003. "Transparency in Government Procurement: the benefits of efficient governance and orientation for achieving it". WP (2002)31 of the Trade Committee.
[56] See Alkire, S., Foster, J., Seth, S., Santos, M. E., Roche, J. M., and Ballon, P. (2015). 'Multidimensional Poverty Measurement and Analysis', Oxford: Oxford University Press.

Reducing public-sector resources allocated to the non-vulnerable population

Prior Action 3: *The Borrower has issued decrees and regulations to: (i) eliminate subsidies for premium gasoline, industrial diesel and natural gas for commercial and industrial use and reduce subsides for other fuels; and (ii) strengthen the Regulatory Agency for Hydrocarbon's mandate/governance by granting this Agency the responsibility of setting final prices of fuel products.*

Prior Action 4: *The Borrower has reduced electricity subsidies by issuing regulations to: (i) improve targeting of social tariffs; (ii) eliminate subsides to off-peak electricity industrial tariffs; and (iii) enforce effective pricing discipline by reducing non-payment and arrears.*

5. **The reduction in gasoline subsidies would not have significant impacts on the welfare of the bottom 40.** The government increased the high-octane gasoline (i.e., super) price in August 2018 from USD 2.32 to USD 2.98 per gallon (as evidenced by Decree 490 dated 23th, August 2018). Four months later, the low-octane gasoline (i.e., extra) price was increased from USD 1.45 to USD 1.85, and the high-octane gasoline price was liberalized to fluctuate according to international prices (as evidenced by Decree 619 dated 21th, December 2018). Before these reforms were implemented, the top of the income distribution captured most of the gasoline subsidies for super and extra. For instance, 30 percent of the wealthiest population benefitted from 80 and 50 percent of the subsidy for high-octane and low-octane gasoline, respectively (Figure A-1 – Panel A). In contrast, the bottom 40 percent of the population captured around 9 percent of subsidies in high-octane and less than a quarter for the low-octane gasoline (Figure A-1 – Panel A). The distributional incidence of gasoline subsidies also shows that for the super-gasoline direct and indirect effects are negligible (Figure A-1 – Panel B). In the case of extra-gasoline direct effects exceed one percent of the per capita income in the first decile while these are lower than half of a percentage point in the rest of the income distribution (Figure A-1 – Panel C). That said, indirect effects for this type of gasoline are similar in magnitude to the direct effects. Thus, the total impact adds up to 2 percentage points of the per capita income for the first decile.

6. **Once the reforms in super and extra gasoline subsidies were implemented, welfare losses were negligible at the bottom of the distribution.** The distributional impact mirrors the results mentioned above in the case of the super-gasoline. However, in the case of the extra-gasoline, its reform partially reduced these subsidies. The distributional impacts of this reform are the difference between Panel C and D of Figure A-1. For instance, the total welfare loss (i.e., direct and indirect effects) for the first decile was 1.5 percentage point of the per capita income and less than one percentage point for the bottom 40 percent. Overall, no poverty impacts are expected.

Figure A-1: Distributive incidence of gasoline subsidies

Panel A: Distribution of gasoline subsidies by income deciles. Pre-Reform	Panel B: Direct and Indirect effect of high-octane gasoline as a share of household per capita income. Pre-Reform

60%
50%
40%
30%
20%
10%
0%
56.4%
20.0%
16.1%
14.0%
10.6%
4.7% 5.2% 6.2% 6.8% 8.1% 8.2%
2.2% 2.0% 2.7% 1.8% 2.4% 2.8% 5.8% 7.5% 16.3%
1 2 3 4 5 6 7 8 9 10
Per capita income decile
Extra Super

Per capita income decile
10 9 8 7 6 5 4 3 2 1
0% 1%
Direct Indirect

Panel C: Direct and Indirect effect of low-octane gasoline as a share of household per capita income. Pre-Reform	Panel D: Direct and Indirect effect of low-octane gasoline as a share of household per capita income. Post-Reform

Per capita income decile
10 0.3%
9 0.4%
8 0.4%
7 0.4%
6 0.3%
5 0.4%
4 0.4%
3 0.5%
2 0.5%
1 1.1%
0% 1% 2% 3%
Direct Indirect

Per capita income decile
10 0.1%
9 0.1%
8 0.2%
7 0.1%
6 0.1%
5 0.1%
4 0.1%
3 0.2%
2 0.2%
1 0.4%
0% 1%
Direct Indirect

Note: Value labels correspond to Direct Effect in panel C and D.
Source: Own estimations based on INEC, ENIGHUR 2012 and ENEMDU 2017

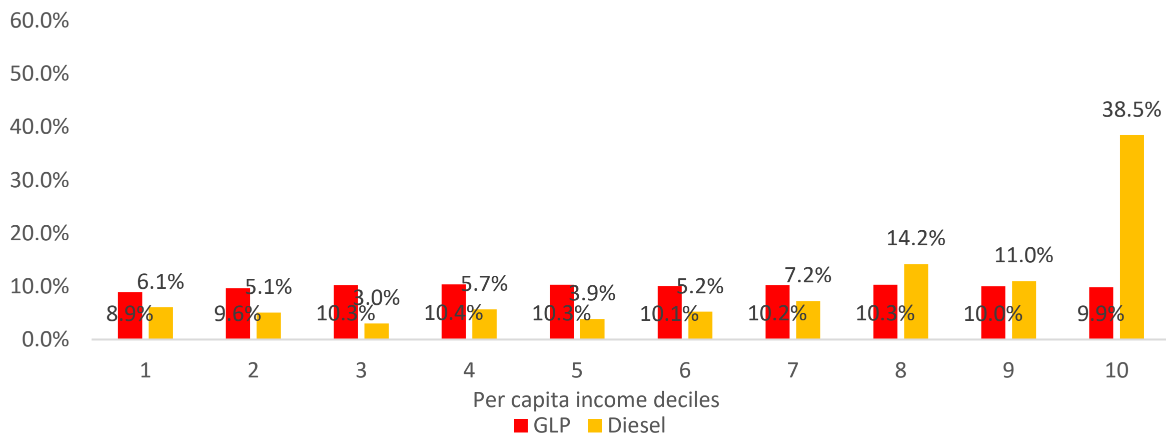
7. **The strengthening of the Regulatory Agency for Hydrocarbon would not produce any poverty nor social impacts in the short-term but significant and negative impacts might happen on vulnerable populations if subsidies in Liquefied Petroleum Gas (LPG) and diesel are eliminated without implementing proper compensation measures.** In contrast to the gasoline subsidies, the poor and vulnerable populations are exposed to substantial direct effects when removing LPG subsidies as well as significant indirect effects when diesel subsidies are eliminated. The LPG subsidies are almost uniformly distributed across the income distribution (Figure A-2- Panel A). Simulation results show that the direct effects of full removal of LPG subsidies would negatively impact the welfare of the bottom 40 (Figure A-2

– Panel B). The welfare loss of the first decile would in around 7 percent of the per capita income. Similarly, this loss would be between 2.2 and 3.4 percent of the per capita income for the rest of the bottom 40. Indirect effects are negligible in the LPG case. Subsidies on diesel are concentrated at the top of the income distribution (Figure A-2 – Panel C). The three top deciles benefit with more than three-fifths of the total subsidies. Its removal has no significant direct effects but large indirect effects. The indirect effects come mostly due to the transport sector by both freight and passengers' services. For instance, the indirect effect for the most deprived decile represents 1.8 percent of their household per capita income and remains high up to the third decile.

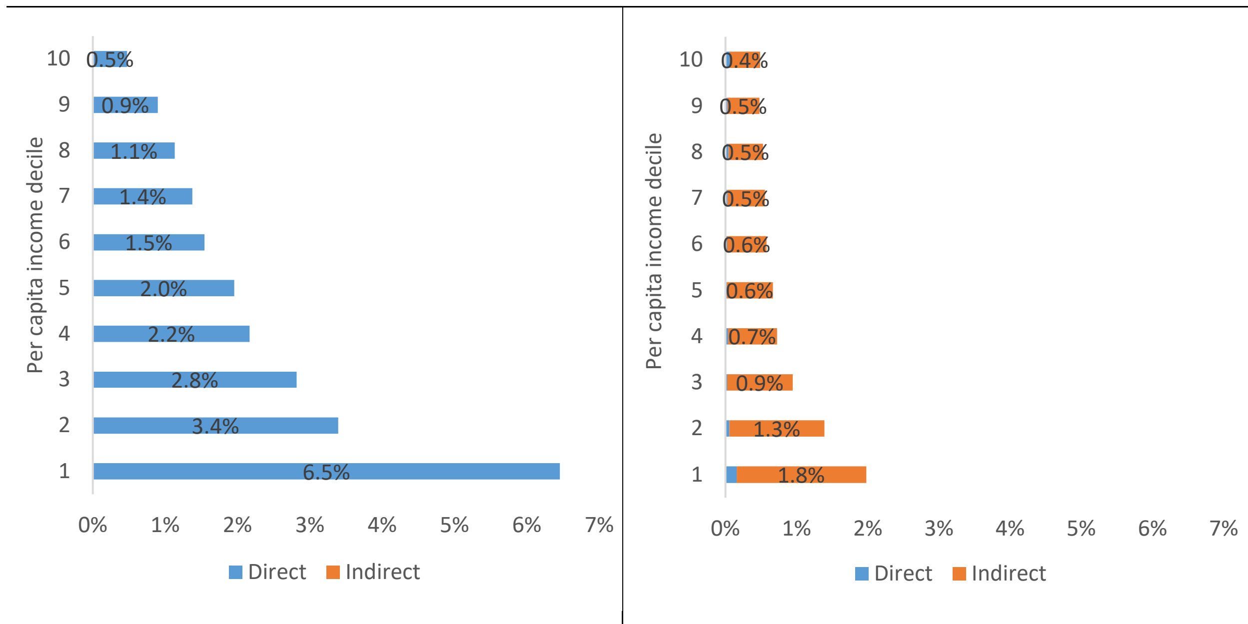
8. **Eliminating the remaining subsidy for low-octane gasoline may amplify the adverse effects.** The elimination of these three remaining fuel subsidies could impact the bottom decile up to 9 percent of its per capita income, considering both direct (7 percent) and indirect effect (2 percent). In this scenario, the government should protect vulnerable populations with a compensation mechanism for which the improvement in the scope and quality of the current Social Registry is a must (see **Prior action 8 in Pillar 3**).

Figure A-2: Distributive incidence of LPG and Diesel subsidies

Panel A: Distribution of LPG and Diesel subsidies by income deciles.



Panel B: Direct and Indirect effect of LPG as a share of household per capita income.	Panel C: Direct and Indirect effect of Diesel as a share of household per capita income.



Note: Value labels correspond to Direct Effect in panel B and to Indirect Effects in panel C.
Source: Team elaboration from INEC, ENIGHUR 2012 and ENEMDU 2017

9. **No significant impacts at the bottom 40 are expected through the improved energy subsidies targeting.** The reform on the electricity pricing aims to rationalize subsidies and promote efficiency through an improved price setting methodology. It revises the criteria to qualify to social tariffs improving its targeting and eliminating subsidies to off-peak industrial tariffs. These actions are complemented by the introduction of the performance-based regulation framework in the electricity sector. According to the last available budget survey, electricity consumption rises sharply with income.[57] Furthermore, 54 percent of households consume less than the dignity tariff threshold. However, access to this subsidy is higher for the lower deciles. The share of eligible households for the dignity tariff is almost 90 percent for the poorest decile, 80 percent for decile 2, and 72 percent for the third decile. Nonetheless, the share remains above 40 percent for remaining households, being the top decile the exception. Thus, there is scope to improve the targeting of the social tariff, mostly reducing the inclusion error. While some exclusion error might be reduced, this would not generate significant impact at the bottom 40 percent. On the other hand, enforcing effective pricing discipline by reducing non-payment and arrears is not expected to impact significantly the household's welfare.

PILLAR 2: REMOVE BARRIERS FOR PRIVATE SECTOR DEVELOPMENT

Prior Action 5: *The Borrower has adopted provisions to require the inclusion of international arbitration clauses in large contracts.*

10. **Prior action 5 is expected to have a neutral impact on poverty reduction and shared prosperity in the short run but a positive effect on economic growth through increased foreign direct investment in the medium to long-run.** Recognizing international arbitration for large contracts is aimed at boosting

[57] World Bank, (2017). "Ecuador: Analysis of energy pricing policies and their distributional impact". Unpublished manuscript.

foreign direct investment, since it gives firms access to more effective contract enforcement and it is more effective at inhibiting rent-seeking litigation actions.[58] However, FDI depends on many factors to materialize. That explains why there should not be any short-term welfare impacts.

11. **Economic literature argues that FDI is an important determinant of poverty reduction by its positive effect on the economic growth rate** (although, authors such as Mold (2004) or Stiglitz (2002) hold a more skeptic view).[59] However, the link between FDI and poverty reduction is complex, and does not boil down to the combination of the average effects of FDI on GDP growth and the average effects of growth on poverty. In particular, FDI is a good mechanism for the rapid and efficient transfer and adoption of best practices across borders, as well as to upgrade human capital, with the potential to promote not only economic growth but also economic development.[60] These benefits are expected to contribute to higher economic growth and economic development, which are considered as the most effective ways to foster the reduction of poverty. However, assuming that the improvement of legal certainty supported by this effectively foster FDI, the precise impact on the poor or the bottom 40 is hard to quantify, although it is expected that larger foreign direct investment across several industries –especially in those with more internal productive linkages– would have a positive effect on welfare, operating through the labor market channel.[61]

12. **FDI can have both direct and indirect effects on poverty reduction.** The direct effect of FDI on poverty reduction comprises increases in employment and reduction of people living below the poverty line due to a higher labor demand, as well as the improvement of workforce and safety nets.[62] The standard neoclassical Solow type steady state growth model focuses on FDI as capital inflow, which enlarges the capital stock of the host country. In the short run, FDI has a positive influence on the host country's growth rate, but in the long run due to diminishing marginal capital returns, the host economy converges to the steady state growth.[63] The economic literature argues that the indirect benefits accrued from FDI include being a source of both capital and transfer of knowledge, but in addition may also include the acquisition of new technology, the contribution to international trade integration, and the increase of tax revenues, all associated with a higher growth rate. From the empirical perspective, Moczadlo (2010) argues that the impact of FDI on growth and poverty reduction could be rather ambiguous,[64] since authors

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[58] Andrew Myburgh and Jordi Paniagua (2016). "Does International Commercial Arbitration Promote Foreign Direct Investment?". The Journal of Law and Economics V 59, N 3, pp. 597-627. Available at: *https://www.journals.uchicago.edu/doi/abs/10.1086/689188*

[59] For Stiglitz (2002), FDI is frequently a mixed blessing, since multinationals exert pressures on developing countries governments which they are typically poorly equipped to resist (see Globalization and its critics, Stiglitz 2002). In addition, other authors point out to the fact that FDI projects may create additional competition to the local industry, endangering local demand for labor.

[60] Klein, Aaron and Hadjimichael (2002). "Foreign direct investment and poverty reduction." World Bank. Available at: *http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2613*

[61] Effects on labor demand might also depend on the type of industries FDI is allowed to enter. Article 313 of the Ecuadorian Constitution reserves for SOE sectors such as energy, telecommunications, non-renewable natural resources, transportation and refining of hydrocarbons, and others which are categorized as "strategic". Mixed public-private enterprises could enter these sectors as long as the State is the primary shareholder.

[62] Hung, T. T., (2004). "Impacts of Foreign Direct Investment on Poverty Reduction in Vietnam" IDS Program, GRIPS. Available in: http://www.grips.ac.jp/vietnam/VDFTokyo/Doc/18TTHungPaper.pdf

[63] See Mello, L. R. (1999). "Foreign direct investment-led growth. Evidence from time series and panel data," Oxford Economic Papers, no. 51, pp. 133–151, 135; and Hudea, O. S.; Stancu S. (2012). "Foreign Direct Investments, Technology Transfer and Economic Growth." In: Romanian Journal of Economic Forecasting no. 2, pp. 85–102, p.85.

[64] Moczdlo, R. (2010). "Foreign direct investment: a mead for poverty reduction." Available at: *https://www.hs-*

like Klein, Aaron and Hadjimichael (2002) conclude that under competitive conditions FDI can upgrade productivity; while Mahmoud (2010) points out that in the field of extractive minerals or fuels FDI has not being associated with poverty reduction and growth.[65] In the particular case of Latin America, using information from 20 countries from the region during the decade of the 1990s, Calvo and Hernandez (2006) suggest that FDI is a potential contributor to poverty reduction.[66] In particular, the authors argue that capital shortage is a factor affecting poverty, and hence FDI can help relax these constraints and be an important path for poverty reduction.

13. **However, certain conditions are necessary for countries to take full advantage of the benefits from FDI.** In principle, FDI is a key ingredient for successful economic growth in developing countries, and since growth is one the most important factors affecting poverty reduction, FDI would be central to this goal (see Klein, Aaron and Hadjimichael, 2002). In addition, it is argued that FDI provides a relatively stable, risk-free, form of finance for development in capital-poor countries. Moreover, FDI has the potential to contribute to the technology acquisition and competitive upgrading of national economies,[67] as well as improve management and labor skills in host countries. However, to achieve the positive outcomes of FDI on poverty reduction, the existence of an equal and competitive playing field without special protections and a general framework of reasonable regulations (i.e., not unduly burdensome and not arbitrary) are necessary.[68] Importantly, using a panel data of 20 Latin American countries, Calvo and Hernandez (2006) suggests that the impact of FDI varies across countries, so that FDI reduces poverty only under certain circumstances, while fails under others.[69] Thus, FDI is not a silver bullet solution, but a part of a more comprehensive poverty reduction strategy.

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pforzheim.de/fileadmin/user_upload/uploads_redakteur_wirtschaft/Fakultaet_zentral/Dokumente/2013/Turmthesen/TT_Bd2_07_Moczadlo.pdf

[65] Mahmoud, A. (2010): FDI, Local Financial Markets, Employment and Poverty Alleviation. *http://ssrn.com/abstract=1638792* (4.7.2011), p. 27.

[66] Calvo, C. and Hernandez, M. (2006). "Foreign Direct Investment and Poverty in Latin America." Prepared to be delivered at the Globalization and Economic Policy Fifth Annual Postgraduate Conference. Leverhulme Centre for Research on Globalisation and Economic Policy. 2006. Available at: *https://www.nottingham.ac.uk/gep/documents/conferences/2006/postgradconf2006/hernandez-postgradconf2006.pdf*

[67] Mold, A. (2004). "FDI and poverty reduction: A critical appraisal of the arguments". *Revue Region et Developpement, No. 20, 2004.*

[68] Klein, Aaron and Hadjimichael (2002:3-4). "Foreign direct investment and poverty reduction." World Bank. Available at: *http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2613*

[69] Calvo, C. and Hernandez, M. (2006). "Foreign Direct Investment and Poverty in Latin America." Prepared to be delivered at the Globalization and Economic Policy Fifth Annual Postgraduate Conference. Leverhulme Centre for Research on Globalisation and Economic Policy. 2006. Available at: *https://www.nottingham.ac.uk/gep/documents/conferences/2006/postgradconf2006/hernandez-postgradconf2006.pdf*

Prior Action 6: *The Borrower has adopted measures to facilitate firm entry, by: (i) including provisions in the Productive Law to strengthen the Limited Liability Modality for firms; and (ii) eliminating the obligation for importers to prove compliance with national technical requirements prior to arrival, replacing it with posteriori risk-based control.*

14. **The reintroduction of the limited liability principle for firms is not expected to have a direct effect on welfare in the short-run. In the medium and long-run an indirect positive welfare effect is expected as a result of an improvement on labor conditions (an increase in formal employment).** The firm limited liability principle is considered one of the most important advantages of incorporation as it reduces the personal financial risks of investing in a business and reduces exit costs in case of failure. This is an important factor for private firm creation and growth. However, positive welfare impacts through increase entrepreneurship and formal labor demand are expected to occur at the medium to long run, since investment decisions take time to adjust to new rules and are made after consideration of a combination of factors and given a set of conditions, that are particular for developing economies[70,71].

15. **Replacing the obligation for importers to prove compliance to national technical requirements with posterior risk-based control is not expected to have direct welfare impacts, neither.** This prior action aims to reduce non-tariff measures and facilitate the importers firm's operation. Removing these barriers would help entrepreneurs spend less time on custom papers. Nonetheless, no significant impacts on quantities nor prices for imported goods are expected. Thus, it is unlucky that a reduction in domestic prices or a change in wages for the relative abundant type of workers will materialize.[72]

Prior Action 7: *The Borrower has reduced distortions on the banking sector by issuing regulations to: (i) eliminate new Central Bank investments in public financial institutions; and (ii) increase bank liquidity by considering allocations to the Liquidity Fund as part of the amount required by the Domestic Liquidity Requirement.*

16. **Eliminating the possibility of a new Central Bank investment on Public Banks would not generate significant welfare impacts.** This prior action not only helps to level the costs of funding between private and public banks but also limits the possibility of quasi-fiscal operations. While the last one would strength macroeconomic resilience, it is not expected to generate welfare impacts. On the other hand, evidence for Latin-American countries finds that promoting competition in the financial sector is associated with reducing bank margins and profitability while improving cost efficiency.[73] These results come from reforms that include deregulation and opening the financial market for foreign participation. Thus, the impacts on the lower interest rate are expected to be modest. Finally, the literature suggests

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[70] Zoltan J. Acs and Nicola Virgill (2010). "Entrepreneurship in developing countries". In: Z.J. Acs, D.B. Audretsch (eds.). *Handbook of Entrepreneurship Research*. International Handbook Series on Entrepreneurship 5, DOI 10.1007/978-1-4419-1191-9_18.
[71] Garry Bruton, David Ahlstrom and Krysztof Obloj (2008). "Entrepreneurship in emerging economies: Where we are today and where should the research go in the future". Entrepreneurship Theory and Practice Vol. 32 Issue 1. Baylor University.
[72] Following the classical Stolper-Samuelson Theorem, as developing countries are typically well endowed with low-skilled labor relative to developed countries, income inequality would be expected to decline in developing countries due to trade openness.
[73] Yildirim, H. and Philippatos, G. (2007). Restructuring, consolidation and competition in Latin American banking markets Journal of Banking & Finance Volume 31, Issue 3, Pages 629-639

that banking must be regulated and well-supervised to avoid fragility in the sector and its consequences, such as the financial crisis.[74]

17. **The reform of liquidity requirement for commercial banks is not expected to have a negative impact on the overall welfare of the less well-off in Ecuador and could have a positive impact through credit growth.** The reform would decrease the overall liquidity reserves, helping commercial banks to meet simultaneous liquidity regulation. As a result, the banks would be available to expand the credit supply. Economic theory predicts a positive relationship between credit expansion and economic growth. [75] Thus, the reform might boost economic activity and job creation. Nonetheless, empirical works find that this link depends on the type of new credits. For instance, an IMF study finds a significant impact of credit growth on real GDP growth, with the magnitude and transmission channel of the impact of credit on real activity depending on the specific type of credit. [76] The results show that corporate credit shocks influence GDP growth mainly through investment, while consumer credit shocks are associated with private consumption. In addition, Adu et al. show that whether financial development is good or bad for growth depends on the indicator used to proxy for financial development.[77] The authors show that both the credit to the private sector as ratios to GDP and total domestic credit is conducive for growth, while broad money stock to GDP ratio is not growth-inducing. Moreover, Banu (2013) show that credits offered to households contribute to the formation of the GDP than credits offered to public administration. Thus, the reform could generate positive welfare impact if credit growth goes mainly to finance private investments and consumption.

PILLAR 3: PROTECT AND INCLUDE VULNERABLE SEGMENTS OF THE POPULATION

Prior Action 8: *The Borrower has: (i) expanded the objectives of the Social Registry; and (ii) approved the creation of a unit within MEF dedicated to the design of compensation mechanisms to mitigate the impact of subsidy reforms.*

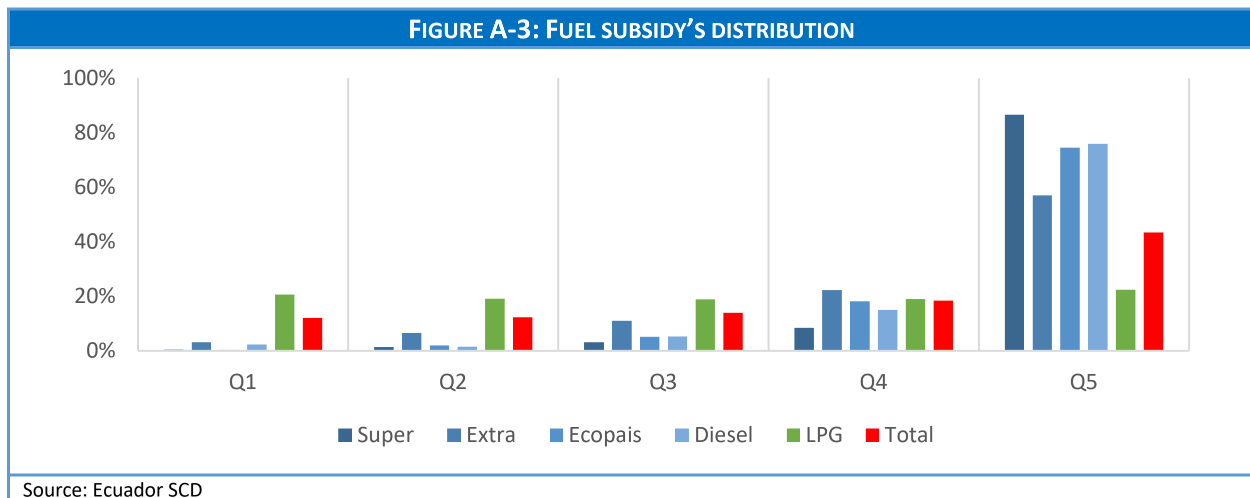
18. **The increase in scope of the Social Registry are not expected to have significant direct welfare effects in the short-run**. The main objectives of this prior action are setting the bases for a proper functioning of the social protection system in Ecuador. On the one hand, the Social Registry contains information on 8 million individuals (roughly 2 million households), mainly from per capita consumption quintiles 1 and 2, covering approximately 48 percent of the Ecuadorian population. Unfortunately, this information does not allow mitigating the removal of energy subsidies which demands expanding the scope of the current SR beyond the bottom of the distribution. The National Secretariat of Planning (SENPLADES) is currently updating the Social Registry dataset. This update process aims to increase the scope of the current Social Registry by gathering information from the population in deciles 1 to 6 with home visits, and in deciles 7 to 10 by demand and use of administrative records. This data collection strategy would produce a robust database that would allow identifying the vulnerable population affected

[74] Beck, T. (2008). Bank competition and financial stability: Friends or foes? World Bank Policy Research Working Paper 4656.
[75] Levine, Ross, 2005. "Finance and Growth: Theory and Evidence," Handbook of Economic Growth, in: Philippe Aghion & Steven Durlauf (ed.), Handbook of Economic Growth, edition 1, volume 1, chapter 12, pages 865-934 Elsevier
[76] Garcia-Escribano, M. and Han, F. (2015). Credit expansion in emerging Markets: propeller of growth?. IMF Working Paper 15/212.
[77] Adu,G. Marbuah, C. and Mensah Justice Tei (2013). Financial development and economic growth in Ghana: Does the measure of financial development matter? Review of Development Finance, 3 192–203.

by the removal of energy subsidies (i.e., removal of extra-gasoline, LPG, diesel and electricity see **Prior Action 3 and 4**).

19. **Even though subsidy schemes are regressive and costly, these represent a higher share of total family income for lower income groups**. The bulk of gasoline and diesel subsidies only benefit households in the richest quintile. Data from the most recent household income and expenditure survey (ENIGHUR 2012) shows that the top 60 percent received between 92 to 99 percent of the gasoline and diesel subsidies in 2012 (Figure A-3). In contrast, subsidies for liquefied petroleum gas are less regressive. Liquefied petroleum gas is the main cooking fuel for 94 percent of all households, and for 76 percent of the poorest 10 percent of households. More importantly, LPG subsidies represent 5.2 percent of total family income for the first decile, which is almost thirteen times higher than what represents for the 10th decile (less than half a percentage point). Thus, a removal of remaining subsidy without setting proper compensation mechanisms for vulnerable populations will negatively impact the welfare of the less well-off.

FIGURE A-3: FUEL SUBSIDY'S DISTRIBUTION



Source: Ecuador SCD

20. **On the other hand, this prior action will also support the creation of a unit within MEF dedicated to mitigating the distributional impact of implementing energy pricing reform**. Having an updated Social Registry, a new targeting index and proper lines to identify extreme and moderate poor will solve the existing focalization problem. Lower fiscal resources triggered by the fall in oil prices together with changes in stricter eligibility conditions for the BDH (Bono de Desarrollo Humano) beneficiaries increased its progressivity but significantly reduced its coverage. The strategy of changes in eligibility criteria only involved the exiting of beneficiaries, but it did not contemplate a process to incorporate potential new beneficiaries. In 2008, the coverage of the BDH program in the bottom quintiles, Q1 and Q2, stood at more than 60 and 50 percent, respectively. By 2016, the share for these two quintiles had dropped to 40 and 26 percent, respectively. These improvements coupled with the expansion of the scope of the Social Registry to vulnerable groups set the essential elements for designing and implementing proper compensation mechanisms for mitigating the adverse impacts of energy pricing reforms, the sole mandate of this unit.

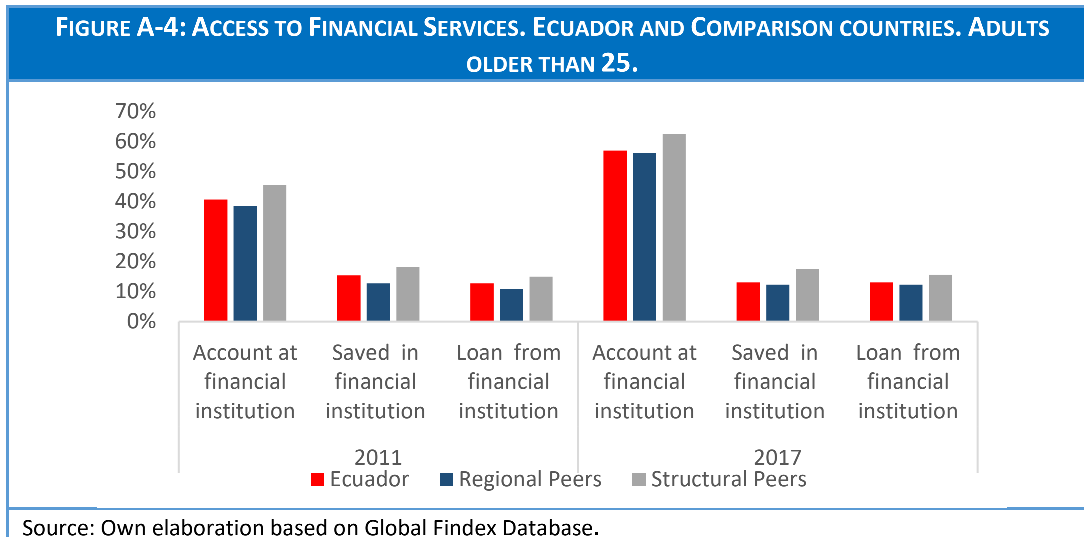
Prior Action 9: *The Borrower has enacted a new law and regulatory framework aiming at preventing and eradicating violence against women to, inter alia, improve their economic opportunities.*

Prior Action 10: *The Borrower has mandated the auditing of CONAFIPS in terms of its capacity to reach vulnerable sectors of the population.*

21. **The audit of the fiduciary fund for cooperatives is not expected to have adverse welfare effects in the short-run, while positive effect could appear in the medium-term due to financial inclusion.** The main objective of this prior action is to assess the quality of CONAFIPS and whether the credits offers by this public financial institution are reaching populations in need via cooperatives or other small financial associations (i.e., community banks). This action is not expected to have welfare impacts in the short run. Nevertheless, it is the first key step to achieve transparency and adequate regulation of the cooperative sector and to expand its reach. If cooperatives banks are strengthened, policies under prior action 9 might have positive impacts on welfare in the medium-term by financial inclusion of lower segments of the population.

22. **Ecuador has made substantial progress in the bank's account penetration, which was not followed by increases in saving and loans in financial institutions.** Between 2011 and 2017, the share of adults holding an account at a financial institution grew 16 percentage point, reaching 57 percent. In the same period, savings and loans in financial institutions remained constant at 15 and 13 percent, respectively. This places Ecuador slightly above to the regional peers and below the structural peers (Figure A-4). Although improvements in access were strongest among disadvantaged groups, significant gaps remain. The last available microdata of Global Findex database for 2014, show that among the bottom 40 only 37 percent of adults has an account at a financial institution, compared to 60 percent for the top 60. This yield a 65 percent gap between the bottom and the top of the distribution. There is also a significant gender gap of 34 percent, which has been shrunken from 43 percent in 2011.

FIGURE A-4: ACCESS TO FINANCIAL SERVICES. ECUADOR AND COMPARISON COUNTRIES. ADULTS OLDER THAN 25.



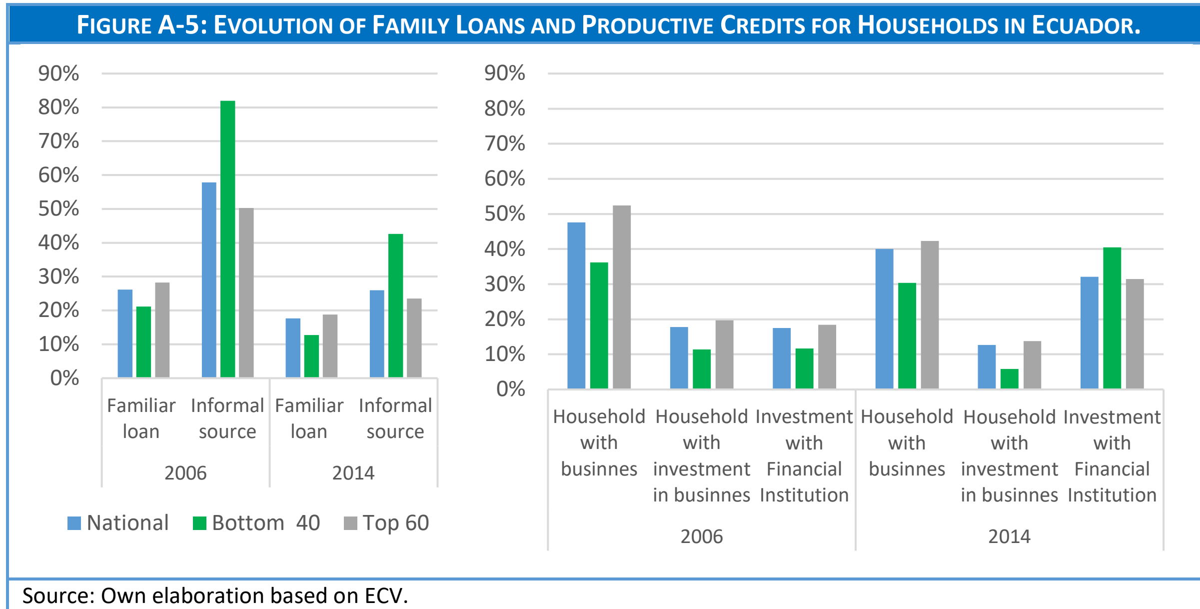
Source: Own elaboration based on Global Findex Database.

23. **Consumption and productive-credits for households shown greater formalization, but a lower access rate.** According to the consumption surveys for 2006 and 2014, the proportion of households with consumption-loans has drastically decreased from 26 to 18 percent, with a sharp drop in the informal

sources from 58 to 26 percent (Figure A-5 – panel A). Productive-loans have followed a similar dynamic. Both the proportion of households with businesses and investments in family businesses decreased from 48 to 40 percent and from 18 to 13 percent, respectively. However, within the households that invested in their businesses, the share of financial institutions as a founding source almost doubled from 17 to 32 percent (Figure A-5 – panel B). Notwithstanding this progress in formal loans, a significant socioeconomic gap persists. For instance, in 2014 the 40 percent of family loans for the bottom 40 was financed by informal source, which contrasts to the 22 percent for the top 60.

24. Financial inclusion can promote growth and reduce poverty and inequality by providing households and firms with greater resource access to face consumption and investment needs as well as to manage financial risks. This will require the expansion of financial intermediation services, by mobilizing savings and reducing credit constraints and cope with potential policy distortions, markets frictions, and inefficiencies.[78] As summarized by a World Bank analysis: "*Evidence shows that financial inclusion allows people to make many everyday financial transactions more efficiently and safely and expand their investment and financial risk management options by using the formal financial system. This is especially relevant for people living in the poorest 40 percent of households. Yet not all financial products are equally effective in reaching development goals, such as reductions in poverty and inequality. Current evidence suggests that the biggest impacts come from savings accounts – provided that they are inexpensive and serve a specific purpose – and digital payments. Research on microcredit's impact is mixed and shows modest, if any, effects. Some studies show that people with insurance invest in riskier, higher return technologies, though little is known about its impact on welfare measures*". [79]

FIGURE A-5: EVOLUTION OF FAMILY LOANS AND PRODUCTIVE CREDITS FOR HOUSEHOLDS IN ECUADOR.



Source: Own elaboration based on ECV.

[78] Evidence for Ecuador finds market frictions or policy distortions for household financial inclusion and excesses or inefficiencies for firms' financial inclusion. Dabla-Norris Era, Yixi Deng, Anna Ivanova, Izable Karpowicz, Filiz Unsal, Eva VanLeemput and Joyce Wong, (2015). "Financial Inclusion: Zooming in on Latin America". IMF Working Paper, WP/15/206.

[79] Demirguc-Kunt, Asli Klapper, Leora and Singer, Dorothe. 2017. "Financial Inclusion and Inclusive Growth: A review of recent empirical evidence". World Bank Policy Research Working Paper #8040.

ANNEX 5: COORDINATION WITH MULTILATERALS

Area	WB	IMF	IADB	Other
Fiscal Adjustment	*	*	*	
Fiscal policy framework				
Other PFM (budget processes, cash management, transparency)	*	*		
Quality of current spending	*	*		
Wage bill, HR	*	*		
Procurement	*			
Subsidies	*			
Debt management	*	*		
Tax policy	*	*		
Tax/custom administration		*	*	
Capital spending				
PIM	*		*	
Asset management			*	
Institutional strengthening of MEF			*	
Social Sectors and Safety Nets				
Efficiency of social spending	*			
Targeting and effectiveness of social programs	*			
Compensation Mechanisms	*			
Pension Reform				
SOE Reform (horizontal)			*	
Monetary/Dollarization		*		
Financial Sector	*	*	*	
Interest rate ceilings, liquidity requirements	*	*	*	
Commercial banks Regulations and supervision				
State-owned banks	*			
Cooperatives	*			
Capital Markets Development				
Private Sector/Private Investment	*		*	
Entry	*		*	
Operation	*		*	
Competition				
Insolvency/bankruptcy				
Arbitration	*			
PPPs	*		*	
Opening/Governance of energy sector+	*		*	
International Trade	*		*	*
Facilitation			*	CAF
Non-tariff barriers	*			
Tariffs and quotas				
Agriculture price floors				
Labor Reform	*			
Anticorruption				
Overall strategy	*	*		UN
Integrity				

+ support by WB through technical assistance

[shaded] areas not covered by any IFIs