

ICR Review  
Operations Evaluation Department

1. Project Data:	Date Posted : 05/07/2004		
PROJ ID : P082739	Appraisal	Actual	
Project Name : Fiscal Consolidation & Competitive Growth	Project Costs 50.0 US\$M )	50.0	
	(US\$M)		
Country : Ecuador	Loan/		
	Loan US\$M ) 50.0		
	/Credit (US\$M)	50.0	
Sector (s): Board: EP - General public administration sector	Cofinancing US\$M )		
	(US\$M)		
	(70%), Other social services (10%), Other domestic and international trade (10%), Telecommunications (5%), Power (5%)		
L/C Number :	Board Approval FY )	03	
	(FY)		
Partners involved :	Closing Date 12/31/2003	12/31/2003	
Prepared by : Pierre M. De Raet	Reviewed by : Poonam Gupta	Group Manager : Kyle Peters	Group : OEDCR

2. Project Objectives and Components

a. Objectives

Overall objective: 1) restore fiscal sustainability with social expenditure protection; and 2) promote faster growth with improved competitiveness.

1) Fiscal consolidation would be achieved through : (i) a sound budget framework; (ii) enhanced revenue management; (iii) improved expenditure management with austerity, transparency, accountability, and tight control of the wage bill; and (iv) prudent debt management.

2) Faster growth with competitiveness would be based on : (i) reform of competition and trade policies; (ii) solid pricing and regulatory policies to attract investment in key basic infrastructure sectors; and (iii) increasing labor market flexibility.

b. Components

1) Fiscal consolidation:

(i) the budget framework would be strengthened by enhancing strategy formulation, removing legal and institutional rigidities impeding the administration of the budget, introducing multi -annual budgeting with quantitative benchmarks,

and improving information available to policy makers and civil society;

(ii) revenue management would be strengthened through broadening the tax base, improving tax administration, and

modernizing the customs administration;

(iii) public expenditure management would be strengthened by implementing an explicit austerity program, including

control of the wage bill; and

(iv) debt management would be improved by clearing debt arrears, adopting a medium -term plan for debt reduction,

and establishing clear rules for managing the Stabilization, Investment and Debt Reduction Fund (FEIREP).

2) Growth and competitiveness.

(i) competition policies would be rationalized and the trade regime liberalized;

(ii) regulatory and pricing policies would be improved in the water, electricity and telecom sectors and the latter would

be made more attractive to private investment and management;

(iii) pricing of petroleum products would be rationalized, the management of the national oil company (PetroEcuador)

would be improved, and environmental regulations in the oil producing areas would be designed and enforced more

effectively; and

(iv) rigidities in the labor market would be reduced .

c. Comments on Project Cost, Financing and Dates

The Loan was a single-tranche operation, the first of a series of three, in support of the first phase of the multi -year

Program for Economic Restructuring and Human Development (PERHD) adopted by the Government in January

2003. It supported several reforms left uncompleted under the 2000 SAL, two tranches of which had been cancelled

due to lack of support in Congress for tax and public sector reforms . The Loan was disbursed upon effectiveness

□(9/16/2003), based on the following measures taken prior to Board presentation :

- submission to Congress of a draft law to improve tax collection by Customs;

- issuance of Decree 44/03 entitled "Norms of Patriotic Savings" establishing a government spending austerity plan;

- adoption by Congress of a 2003 budget law complying with Decree 44/03 and with the Law on Transparency;

- adoption by the ministry of finance of a transparency plan based on SIGEF;

- completion by the ministry of finance and the ministry of labor of a final draft for a Public Sector Wage Unification

Law;

- clearance by the ministry of finance of all external debt arrears accumulated up to February 28, 2003, and of all

domestic bonded arrears accumulated up to March 31, 2003;

- issuance by COMEXI of Resolution N. 186 dated January 17, 2003, reversing selective import tariff concessions by

end of 2003;

- issuance by COMEXI of Resolution N. 183 dated January 8, 2003, unifying all remaining import licenses;

- issuance by CONELEC of Resolution N . 028/03 of January 31, 2003, adjusting electricity tariffs for residential

consumers whose consumption is below 300Kwh/month; and

- award by CONATEL of a third mobile telephony license and adoption by CONAM of a strategy for the further

modernization of the telecom sector .

3. Achievement of Relevant Objectives:

1) The objective of restoring fiscal sustainability was not achieved :

(i) although the implementation decree of the 2002 Fiscal Transparency, Stability, and Responsibility Law

was

issued, the budgetary framework was not improved as a tool of fiscal policy and strategy : a new tax law was not

adopted; legal and institutional rigidities in the form of tax earmarking and exemptions were not removed; and

multi-annual budgeting was not introduced; as a result, expansionary spending continued in 2003;

(ii) no progress was achieved in broadening the tax base and in raising non -oil tax revenue; tax revenues from

foreign trade declined in 2003, despite rising trade; the Law on Tax Rationalization, the center piece of the reform,

was not adopted; a new Customs Administration Law was adopted but with watered down provisions and its effective

implementation delayed due to resistance (it now awaits approval of a strategic modernization plan );

(iii) despite the issuance of the Austerity Decree of February 2003, public expenditures, notably the wage bill, were

not contained in 2003; an Organic Law on the Civil Service and Administrative Career and on the Unification and

Uniformization of Public Sector Remuneration was adopted, but it was also watered down covering only 40 percent of

civil servants (teachers, military and police are exempted from the law ); only initial steps were taken to improve

information and transparency of financial management by initiating the upgrading of the MIS, introducing an

e-procurement system for public procurement (a new Procurement Law is under preparation ), and developing a M&E

system for the PIP;

(iv) in the area of fiscal consolidation, only debt management was improved : arrears targeted for clearance in 2003

were cleared, a Debt Reduction Plan was adopted, and a mechanism allocating part of the net revenues from the

sale of heavy crude oil to debt repurchasing was also adopted .

2) The objective of promoting faster growth with competitiveness was not achieved :

(i) the adoption of a new Law on Competition Policy and of a Law on Administrative Simplification was delayed; the

formulation of a Trade Policy Strategy was also delayed; only some duplicate import licensing was eliminated and

technical norms incompatible with WTO prohibited;

(ii) very little progress was achieved in structural reforms : the restructuring of the Sub-secretariat for Potable Water

and Basic Sanitation was approved but not yet implemented, while the adoption of new Water and Sanitation Law,

including the regulatory framework, was delayed; electricity tariffs were raised to 85 percent of economic costs and a

strategy to increase sector efficiency is being prepared, but an attempt to attract private participation failed; the two

major telecom companies achieved operational surpluses in 2003 and a private administrator was identified for the

third mobile telephone company (Telecsa), but no progress was achieved in restructuring the telecom sector as a

whole and a new Telecom Law is not envisaged before mid -2005; reforms in both the electricity and telecom sectors

met strong resistance;

(iii) gasoline and diesel prices were raised for 2003, but were frozen for 2004; subsidies to PetroEcuador were

reduced in the 2003 and 2004 finance laws; and  
(iv) an evaluation of the labor market was completed in consultation with employers and workers .

Based on the lack of tangible progress on reforms between Board approval and March 2004, it is clear that the conditionality required for Board presentation was inadequate to achieve the objectives . At preparation/appraisal, there was insufficient attention to the fact that the reforms previously identified as critical to achieve the stated objectives had stalled, and therefore that the probability of success this time was low . The conditionality should have focused on what was critical to achieve the intended objectives, such as adoption by Congress of satisfactory laws and effective implementation of plans and programs . Also, the Bank should have ensured that policies and reforms were not only owned but also viable at the national level .

#### 4. Significant Outcomes/Impacts:

□ 1) Some reform laws were adopted (Customs Modernization and Organic Law on the Civil Service ).  
2) A Debt Reduction Plan was adopted and a Fund for Stabilization, Investment, and Public Debt Reduction (FEIREP) created to ensure debt repurchasing .

#### 5. Significant Shortcomings (including non-compliance with safeguard policies):

1) The macro-economic situation remained very fragile in 2003. Despite the good performance of the oil sector, which rose by 8 percent (due to the opening of the new pipeline in the last quarter ), overall GDP growth was lower at 2.5 percent than in 2002 (3.3 percent), as a result of a poor performance of the non -oil sector, which grew by 2.3 percent only. The second and third reviews under the March 2003 IMF Stand-by were not completed for lack of

progress on the fiscal (budget targets for 2003 were not met) and structural fronts.

2) Prospects for fiscal consolidation remain uncertain at best : (i) the fiscal impact of the draft Tax Rationalization Law

(now expected to be submitted to Congress by mid -2004) is likely to fall short of what is needed to reach the medium-term objectives of the program; (ii) in approving the Customs Modernization Law, Congress watered down several provisions; (iii) the new Organic Law on the Civil Service, aimed at rationalizing employment and salaries in the public sector, covers only 40 percent of civil servants; and (iv) there is no effective plan to reverse expansionary spending.

3) The continued delay in the adoption of a comprehensive tax reform law is a major cause for concern .

4) The structure of tax revenue remains inadequate, with total revenues highly dependent on oil prices : the tax base

was not broadened and non -petroleum tax revenues declined in 2003, illustrating the vulnerability of Ecuador to external shocks. High oil prices and the opening of the new pipeline have reduced the pressure on the Government to revise its tax policies and legislation .

5) The persistent tendency in Congress to dilute or water down draft legislation submitted by the Executive is

indicative of the lack of national consensus .

6) The weak legal/institutional capacity jeopardizes the effective and speedy implementation of some legislative and regulatory texts.

7) Corruption is very high, especially in the Customs Administration .

In response to the ICR review, Mr . Marcelo Giugale, the Country Director for Ecuador, notes that : " The Region disagrees with OED'

OED 's ratings, which should all have been "satisfactory ". On Outcomes , inflation declined, GDP grew 2.7 percent, and fiscal

to -GDP declined, and the fiscal primary surplus and reserves and external balances improved . On Sustainability , debt -to- increased significantly, partly due to satisfactory compliance with the fiscal rule . On Bank Performance , prior actions met reflected a project design that thus far has achieved the stated objectives of restoring fiscal sustainability and fostering growth, leaving behind a long history of disappointment . On Borrower Performance , domestic consensus (including support from indigenous organization and civil society ) led to the approval of key Customs and Civil Service Laws, another first -ever for this country ."

6. Ratings :	ICR	OED Review	Reason for Disagreement /Comments
Outcome : Satisfactory and		Unsatisfactory	The objectives of fiscal consolidation of faster growth with competitiveness were not achieved (Sections 3 and 5).
Institutional Dev .: Modest Sustainability : Likely		Modest Unlikely	Congress has rejected important draft legislations in the past (e.g., the draft Law of Simplified Tax Regime in May 2003), or watered them down (e.g., the Customs Modernization Law in April 2003). This reflects continued strong resistance from vested interests. Potential benefits from reform are not well understood by the public at large.
Bank Performance : Satisfactory unsatisfactory .		Unsatisfactory	Quality at entry was Project design included conditions that were not sufficient to achieve the loan's stated objectives. For instance, adoption of a revised Tax Law meeting the requirements for fiscal consolidation and of a new Telecom Law should have been part of the conditionality. Similarly for the actual implementation of the new Customs Law.
Borrower Perf .: Satisfactory failed to		Unsatisfactory	At preparation, the Government build a national consensus with Congress and other stakeholders on the content and scope of the program; during execution, considerable delays or outright opposition in Congress to the adoption of laws or to their effective implementation had the effect of diluting the content of the
□			

program and jeopardizing the realization of its expected benefits.

Quality of ICR :

Satisfactory

NOTE:

NOTE ICR rating values flagged with ' \* ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1) In designing adjustment operations and their conditionality, preparation /appraisal teams should draw on the

lessons learned from past operations and focus on the key reforms needed to achieve the objectives .

2) In highly volatile countries, an intense and broad dialogue at the national level (Government, Parliament, civil

society, NGOs, universities, and media ) is critical in building the consensus required for successfully implementing

the reforms; in the same vein, appraisal teams should be sensitive to the potential gap between decision - making or

legislative action on the one hand and effective implementation and enforcement on the other .

8. Assessment Recommended? Yes No

Why? As part of a cluster PPAR covering the SAL and the subsequent operations to assess Ecuador's

and Bank's experience and performance in overcoming a major political and economic crisis .

9. Comments on Quality of ICR:

The ICR is of good quality, very well written and comprehensive . Two remarks are called for, however :

1) Since this is the first operation of a series, the ICR should have assessed whether the original framework of the

multi-year program remained valid.

2) When discussing Factors Affecting Implementation and Outcome, all branches of Government (Executive,

Legislative, and Judiciary) are to be considered as a single entity - the Borrower, in the sense of State or Nation . In

this case, opposition in Congress should not be considered as a factor outside the control of the Government, but

rather as a factor subject to control .

□