Ecuador

Macroeconomic Stability and Competitiveness Challenges

Bolivia, Chile, Ecuador, and Peru

Country Management Unit

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Contents

Introduction .................................................................................................................. Error! Bookmark not defined.

Economic Context ........................................................................................................ 5

Fiscal Consolidation and Efficiency of the Public Sector ............................................. 7
   Ecuador’s Tax System ................................................................................................ 10

Improving Public Spending ....................................................................................... 12
   Public Investment Management ............................................................................ 12
   Public Financial Management ............................................................................... 13
   Public-Sector Wage Bill ........................................................................................ 14
   Improving Strategic Public Procurement ............................................................. 15
   Energy Subsidies .................................................................................................. 18
   Efficiency of Public Spending in Education .......................................................... 19

Restoring Competitiveness ....................................................................................... 19
   Labor Market Regulations .................................................................................... 21
   Financial Sector .................................................................................................... 23
   Agriculture Price Support Policies ........................................................................ 27

Invigorating private sector investment, trade, and employment generation ............... 29
   Status of International Integration ........................................................................ 29
   Trade Performance ................................................................................................. 29
   Recent FDI dynamics ............................................................................................. 31
   Connection to Global Value Chains ..................................................................... 32
   Institutional framework for trade and for investment policy and promotion .......... 33
   A Modern Trade Policy Standpoint ....................................................................... 35

Final Considerations .................................................................................................. 38

Annex: Summary of Policy Recommendations ........................................................ 38

References .................................................................................................................. 42
Forward

The “Macroeconomic Stability and Competitiveness Challenges” note presents the main findings of a large body of work produced under the World Bank Competitiveness Flagship, developed by the EFI team for Ecuador. The Flagship offered a combination of analysis, capacity building, and options for reform in selected areas identified in coordination with the government. This activity has been instrumental in the context of reengagement with Ecuador’s government and preparation of the first full-fledge Country Partnership Framework since 2017. The Flagship also informed the design and preparation of the Inclusive and Sustained Growth DPL series. It also served as input for broader multi-donor effort to support the implementation of an ambitious reform program aimed at addressing macroeconomic imbalances, reigniting private investment, and including vulnerable segments of the population.

The note was compiled by Barbara Cunha drawing from the Public Finance Review (led by Barbara Cunha), Trade, Investment, and Competitiveness Report (co-lead by Daniel Reyes and Barbara Cunha), Financial Stability and Inclusion Report (led by Heinz Rudolph), Public Investment Management Technical Assistance (led by Laura Zoratto). The note benefited from comments and guidance from Alberto Rodriguez, Pedro Luiz Rodriguez, Jorge Araujo, Fernando Blanco, Heinz Rudolph, Daniel Reyes, and Laura Zoratto. The note also benefited from excellent comments from the peer reviewers: David Rosenblatt and Abha Prasad.

This policy note diagnoses the nature of the imbalances faced by Ecuador’s economy and identifies key areas for reform that will contribute to reestablishing macroeconomic stability and increase the competitiveness of the Ecuadorian economy, while safeguarding recent social gains. It systematically presents policy options to be consider within each area. The note does not intent to be exhaustive with respect to the macroeconomic and competitiveness challenges faced by Ecuador. It focuses on critical issues selected in coordination with Ecuadorian authorities, building on and complementing the findings of the Ecuador SCD (2018). In the name of selectivity, the note does not address important issues such as Venezuelan migration, climate changes, and aspects related with doing business. These issues, which have macro and competitiveness implications, are been covered by other World Bank activities. Finally, the note presents an initial diagnostic of the impacts of labor market regulations on competitiveness. However, this issue will be analyzed in more depth in the upcoming Ecuador Jobs Flagship, expected in FY20.
Introduction

Ecuador has embarked on a new policy course. The country faces the challenge of consolidating the social gains achieved during the last decade while addressing the excesses committed during the commodity boom period, when the state was the main drive of economic growth and the private sector remained subdued. Achieving additional social and economic progress will require bringing the economy to a balanced and sustainable path, where a productive private sector plays an important role. This policy note diagnoses the nature of the imbalances faced by Ecuador’s economy and identifies key areas for reform that will contribute to reestablishing macroeconomic stability and increase the competitiveness, while safeguarding recent social gains.

Restoring prudence to fiscal policy will help achieve fiscal sustainability and improve competitiveness. The end of the commodity boom revealed a mismatch between public spending and the ability to finance it. A broad-based fiscal reform, which addresses both excessive public spending and inefficiencies in the tax system, would go a long way towards sustainability. Realignment of the public sector wage bill, an optimization of the system of fuel subsidies, and reduction in public spending on capital and goods and services are important components of expenditure reform. The tax reform should aim to make the tax system more equitable, growth friendly, and simpler. While these fiscal efforts might in the near-term generate headwinds to growth, they will lay the foundation for a more sustainable and equitable growth in the future.

Increasing competitiveness and productivity will require complementing fiscal efforts with core supply side reforms to create a flexible and conducive regulatory environment for the private sector. While Ecuador had a relatively successful first round of private sector-oriented reforms with the approval of the Law on Productive Development, the country’s regulatory framework is far from being conducive to business and still imposes costs and distortions that undermine competitiveness. For example, rigid regulations and price and wage controls have prevent the adjustment of relatively prices and costs. In a dollarized economy, these adjustments are the only instrument for aligning economic fundamentals with external conditions and correct the real exchange rate appreciation. Labor markets, the financial sector, and agricultural products are particularly affected by rigidities and are priority sectors for the next round of structural reforms.

Pursuing the integration and internationalization of the Ecuadorian economy is a key to foster a private-sector-led and productivity-driven economic model going forward. The State-led growth model that prevailed during the commodity boom had an inward-looking perspective on the country’s development process. It encouraged import substitutions through tariff and non-tariff barriers, dismantled investment agreements, initiated the renegotiation of contracts with foreign investors, and taxed capital outflows. These measures were intensified to contain dollar outflows after oil prices dropped. While these policies contributed to an increase in domestic value added, they increased the perceived costs and risks of investors and exporters. As a result, FDI and non-oil exports remained subdued during the last decade. As Ecuador pursues a transition to a balanced, productivity-driven growth model, it is critical to establish and maintain connections to international markets through exports, imports, Foreign Direct Investment (FDI), and Global Value Chains (GVCs). These connections help expand market opportunities of local enterprises and increase their scale and productivity, thereby supporting an efficient reallocation of factors of
production in the economy. This effort should accompany and align with fiscal and regulatory reforms to avoid amplifying external imbalances.

This note identifies key areas that could be considered as part of a medium-term reform agenda to reestablish macroeconomic stability and increase the competitiveness of the Ecuadorian economy, while safeguarding recent social gains. It systematically presents a brief diagnostic together with policy options to be consider within each policy area. The note draws from the findings of a body of analytical work produced by the World Bank during the last two years, including Ecuador SCD; Public Finance Review -Parts I and II; Trade, Investment, and Competitiveness Report; Financial Sector Report, Energy Subsidy Reform Technical Assistance, and Public Investment Management Technical Assistance. This body of analytical work concludes that actions are needed on the following three fronts:

I. **Fiscal consolidation and public sector efficiency**: to downsize public sector demand and return to fiscal and external sustainability;
II. **Restoring competitiveness**: by increasing flexibility of prices and mobility of factor toward more productive activities; and
III. **Invigorating private sector investment, trade, and employment generation**: by creating conditions for the private sector to take a more prominent role as the state adjusts and seize the opportunities created by the newly regained competitiveness.

**Economic Context**

**Ecuador achieved substantial economic and social gains over the 2001-2014 period.** Annual growth in real GDP averaged 4.5 percent, the second highest among Latin American economies. During this period, real GDP increased 79 percent and real GDP per capita increased by 43 percent, helping Ecuador’s per capita income (US$ 10,459 Purchasing Power Parity 2011) cross the World Bank’s upper middle-income threshold. During this time, the income of the poorest 40 percent of Ecuadorians (the ‘bottom 40’) increased substantially faster than the national average (approximately 7 percent annual average).

**Social indicators improved markedly during the boom.** High economic growth and changes in the distribution of income helped lift 1.4 million people out of poverty. Monetary poverty fell from 36.7 percent in 2007 to 22.5 percent in 2014. Both labor income and public transfers contributed to this outcome. Inequality declined significantly with the Gini index dropping 9 percentage points over the decade, reaching 0.46 in 2014. Access to basic services also improved. Between 2007 and 2014, infant mortality rate fell by one-third and the under-five mortality rate decreased by one-fourth. Access to basic education became close to universal and net enrollment rates in upper-secondary and tertiary education increased by 19 and 14 percentage points, respectively, during this period.

**Growth and social gains were driven mainly by an expansion of the state, financed by the commodity windfall.** Public sector demand, driven by public investment and consumption, became the main driver of growth, accounting for two-thirds of the 4.4 percent average annual growth between 2007 and 2014. Public spending increased exceptionally from 21 percent of GDP in 2006 to 46 percent by 2014, well above Ecuador’s regional and structural peers.\(^1\) This expansion, driven by public investment and wages, was

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\(^{1}\) Regional and structural peers are selected based on the following criteria: GDP per capita, population, dependence on commodity revenues. As a result, the countries identified are the following: Argentina, Brazil, Colombia, Chile, Mexico and Peru (regional peers); Kazakhstan, Malaysia, Romania, and South Africa (structural peers).
financed by large oil revenues\(^2\), expansion of tax revenues, reductions in savings\(^3\) and new debt accumulation.

**The Ecuadorian economic model started to signal imbalances even before the fall in oil prices.** Small fiscal savings during the early boom years were depleted while oil prices were still high. As a result, Ecuador had limited fiscal buffers, which prevented a smooth adjustment to lower oil prices. On the back of ambitious investment plans after 2007, Ecuador’s fiscal deficit widened to around five percent of GDP in 2013-14. Public debt started to climb as the fiscal deficit worsened, doubling between 2010 and 2014. During this time, the combination of strong domestic demand and high labor costs drove up real exchange rates. Wage increases outpaced productivity growth and the regulatory environment became less conducive for the private sector, leading to a deterioration in competitiveness. Estimates indicate an overvaluation of up to 20 percent by 2014, consistent with the symptoms of Dutch disease.

**The fall in oil prices and appreciation in the U.S. dollar in 2014–15 caused an abrupt downturn in Ecuador’s fully dollarized economy and further weakened the country’s external position.** As oil prices declined in 2014, macroeconomic and structural vulnerabilities came to the fore, hitting the Ecuadorian economy hard. Government revenues plummeted, and as fiscal buffers were limited, spending also declined quickly, mainly due to cuts in public investment. Lower oil exports and the appreciation of the dollar vis-à-vis neighboring countries intensified external imbalance and led to a sharp decline in external reserves. After five consecutive quarters of contraction, in the midst of which there was both a change in government and a major earthquake, the economy returned to growth at the end of 2016, with a rebound of 2.4 percent in 2017 and slight decline to 1.4 in 2018. During this period, poverty reduction stalled.

**An unsustainable fiscal path has been at the core of Ecuador’s imbalances, which are now starting to be gradually corrected.** The 2014 oil price decline exposed the underlying structural imbalances of Ecuador’s economy. Despite efforts to cut spending the fiscal deficits widened quickly, arrears accumulated, and the public debt increased. The non-financial public sector (NFPS) deficit peaked at 7.3 percent of GDP in 2016. By 2017, a rebound in oil prices, cuts to capital spending, a public sector hiring freeze, and the introduction of temporary tax measures led to a reduction in the fiscal deficit to a still-high 4.5 percent of GDP. In 2018, further cuts to capital spending and higher oil prices helped lower the deficit to 1.2 percent of GDP. The central government deficit declined was modest, from 5.6 percent in 2016 to an estimated 3.8 percent in 2018. During this period, investor confidence was eroded by lower oil prices and uncertainties surrounding the accurate measurement of the level of the public debt, making it difficult for Ecuador to meet its large financing needs.

**Amid recent improvements in the business climate, private investment is slightly recovering and partially cushioning the effect of cuts in public investment, but the weak external position still harm competitiveness.** Ecuador’s regulations governing the labor market, business, and finance, combined to high operating costs, frequent changes in taxes and tariffs, and the weak enforcement of contracts led to an underperforming and underinvested private sector during the boom years. Ecuador still faces a weak external position. The current account has been adjusting to the 2014–15 oil price shock, largely through a compression of imports, but the 2018 cyclically-adjusted current account deficit remains at 3.7 percent of GDP when compared to current account norm (surplus of 3 percent of the GDP).\(^4\) This analysis suggests

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\(^2\) Which benefited from high international oil prices and the renegotiation of oil explorations contracts in 2011,

\(^3\) In 2008, Ecuador dismantled it sovereign oil funds, and use the resources to finance the budget.

\(^4\) IMF Article IV report 2019.
an estimated 30 percent real exchange appreciation. Initial policy reforms have helped improve the investment climate starting in 2017, resulting in an increased in private investment since then. The Government also repealed the import surcharges, dropped the tax on real estate capital gains introduced in 2016, and signed free trade agreements with the European Union (2016) and the European Free Trade Association (2018). In the oil sector, the Government introduced a law to reinstate production sharing agreements which are more attractive to private investors. 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, including the reinstatement of international arbitration in large contracts.

In this context, Ecuador faces an important medium-term reform agenda that will build upon recent reforms and ensure that the income and social gains of the boom period can be sustained and amplified.

Fiscal Consolidation and Efficiency of the Public Sector

Fostered by higher fiscal resources, Ecuador experienced a widespread expansion of public spending starting in 2007. Government spending, measured by spending of the non-financial public sector (NFPS), remained stable during the first half of the 2000s, but doubled as a share of GDP between 2006 and 2014, when it reached 43 percent. This expansion was enabled by an increase in fiscal revenues. Oil-associated revenues, including the balance of state-owned enterprises (SOEs) in the oil sector, accounted for two-thirds of the increase, while gains in the collection of non-oil revenues explained the other one third. Spending was also partially covered by reducing savings and accumulating new debt. Over the 2006-2014 period, current spending expanded by 11.5 percentage points of GDP, 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. Spending in goods and services increased sharply during the last two years driven by recurrent cost associated with investment projects. Capital expenditure expanded by about 9.5 percentage points of GDP between 2006 and 2014, becoming the largest among regional peers. This was as a consequence of sizable investments in infrastructure and energy, as well as in social programs. From a functional point of view, general services experienced a large expansion (6 percent of GDP), followed by transport and energy (2.5 percent of GDP) – mostly capital spending, health and education (2.4 percent of GDP), and social protection (0.7 percent of GDP).

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5 In 2008, Ecuador dismantled it sovereign oil funds, and use the resources to finance the budget.
6 Spending on goods and services remained stable as a share of GDP. 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 meet their requirements. 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 million per year.
Despite initial efforts to curb public spending, the fiscal deficit widened, and the public debt soared, driven by the strong revenue fall. When oil prices dropped in 2014, fiscal revenue as a share of GDP fell by seven percentage points and the gap between public spending and revenues amplified. This occurred in spite of cuts in capital spending, a lower subsidy bill, and attempts to contain current spending. 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. However, the selective default in 2008 and the lack of macroeconomic buffers increased the country’s risk ratings, limiting access to the external funding. The alternative financing sources used included a mix of 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. The fiscal deficit remained above 4.5 percent between 2014-2017 and NFPS debt increased from 27 percent of GDP in 2014 to 45 percent in 2017.

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7 From less than 1 percent of GDP on average in 2010-2013.
8 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.
A recent agreement with the International Monetary Fund (IMF) has ratified the government’s commitment to fiscal consolidation and has helped mobilize additional financing. The government’s plan\(^9\) acknowledges that Ecuador needs to stabilize its fiscal accounts, while also protecting the most vulnerable population and igniting private sector development. In this context, the government has signed an Extended Fund Facility with the IMF to support its macroeconomic reform agenda. The IMF operation, in the amount of US$4.2 billion over three years, is part of a US$10.3 billion financing package. It helped secure financing from the CAF Development Bank of Latin America (US$1.8 billion), the World Bank (US$1.7 billion), the Inter-American Development Bank (US$1.7 billion), the European Development Bank (US$379 million), the Latin American Reserve Fund (US$280 million), and the French Development Agency (US$150 million).

Going forward, it is critical that Ecuador finds a well-paced and credible fiscal adjustment path that helps mitigate risks and safeguards the country’s dollarization regime. Finding the right pace of adjustment will be challenging. Adjusting too quickly could place the country in a recession as the government has been a primary engine of growth. Conversely, adjusting too slowly will not build the credibility that is needed with markets and could expose the economy to shocks that could threaten sustainability. On the external front, risks stem from changes in external financing conditions that limit Ecuador’s access to financing resources. Domestically, Ecuador is vulnerable to natural disasters, which implies potentially high contingent liabilities for the public sector. Finally, any fiscal stabilization plan must safeguard the country’s social gains.

Implementing a balanced fiscal adjustment should entail reforms to address rigidities and increase efficiency of spending and revenue collection. Having a public investment management strategy that carefully prioritizes new investments and ensures that recently built infrastructure obtains positive rates of return is a necessary precondition for a successful adjustment. But this is not sufficient and should be complemented by concrete measures to rationalize the increasingly rigid current spending. Ecuador’s

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\(^9\) Plan Prosperidad
sharp increase in public spending was associated with increased inefficiencies leading to underutilized infrastructure, costly staffing decisions, sub-optimal procurement standards and poorly-targeted social spending, especially in education. Addressing these inefficiencies will be critical to achieving the desired fiscal savings, while also safeguarding social progress. Finally, there is room for raising non-oil revenues and increasing the efficiency of the tax system. Ecuador has improved revenue collection, but non-oil revenues are still relatively low and collected through relatively distortive taxes.

This section analyzes key areas where these efficiency gains could be achieved, including an analysis of Ecuador’s tax system, a review of public investment and financial management, an analysis of public employment and wage bill dynamics, and an assessment of the procurement process and its outcomes, and a review of energy subsidies. It also includes a brief discussion on the efficiency of education spending.

Ecuador’s Tax System

Ecuador has made important improvements in revenue collection during the last decade, but revenues as a share of GDP are still low compared to peer countries. Tax revenues rose from 10.9 percent of GDP in 2008 to 15.7 percent in 2015. Since then, however, the trend has reversed, with tax revenues falling by almost one percentage point of GDP in 2016-2018. This was partly the result of the economic slowdown during this period and partly due to the phasing-out of temporary increases on import tariffs and in the VAT rate. An international comparison of tax revenue as a share of GDP shows that Ecuador ranks lowest among the group of regional and structural peer countries and far below the OECD average of 34 percent of GDP. At over 30 percent of GDP, relative tax revenues in Argentina and Brazil (regional peers), as well as in Poland, are twice as large as in Ecuador. Ecuador underperforms in terms of revenue collection in almost all tax modalities, with the exception of import tariffs.

Low revenue collection relates to low rates, especially for the value added tax (VAT), where collection is relatively efficient. VAT is levied at a low rate of 12 percent, representing a key constraint to tax revenue growth. Ecuador’s VAT rate is significantly lower than that of all peer countries. Ecuador’s VAT C-efficiency has increased and is now close to the averages for regional and structural peers but remains well below the high-income group. Excise taxes are levied on a relatively standard set of goods, except for fuels, yet the revenue remains at 1 percent of GDP - below all peers except for Brazil. Ecuador’s corporate income tax design is similar to those of peer countries, although tax rates are on the low side and exemptions are on the high side of the spectrum of peer countries. The personal income tax (PIT) is well-designed and progressive on paper but not in practice. The minimum and maximum PIT rates in Ecuador, at 5 percent and 35 percent, respectively, are broadly on par with regional and structural peers. However, deductions undermine the progressivity and collection capacity of the PIT. The reduction in Ecuador’s Gini coefficient attributable to the PIT is only 1.4 percent, well short of the result for regional and OECD peers. PIT yields are also significantly lower than in peer countries.

Tax expenditures are high compared to regional peers, in particular for the corporate income tax (CIT). Tax expenditures reached about 4.6 percent of GDP in 2016, of which 2.1 percentage points were due to income tax exemptions (personal and corporate) and 2.1 percentage points were due to VAT exemptions. CIT expenditures arise mainly because of credits for the tax on capital outflows. This tax, which is

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10 For the purpose of this sections: Argentina, Brazil, Colombia, Chile, Mexico and Peru are consider among regional peers; Azerbaijan, Kazakhstan, Malaysia, Romania, South Africa, and Thailand represent structural peers. Poland was selected as a new high-income country (combined with the structural peers in the color coding of the graphs).
creditable against the CIT, represents 24 percent of CIT expenditures. Incentive schemes under the CIT are numerous. However, uptake is low, which mitigates concerns about distortions and tax base erosion. The objective of most incentive schemes is to support sectors subject to competition from neighboring countries or develop economic activity in specific rural areas. The VAT expenditures are due mostly to the large number of exempt goods. The list of zero-rated goods includes food products, agricultural inputs, medicine and health services, educational materials and services, utilities and transport, in addition to exports. The fact that hybrid and electrical vehicles (below a maximum value) as well as electric kitchens are also zero-rated can be justified on environmental grounds. However, zero-rating of airplanes, helicopters, and tourism packages likely benefits higher-income individuals that travel internationally.

The tax administration has a strong enforcement capacity. Enforcement activities are conducted systematically on the extensive (non-filing) and the intensive (misreporting) margin of compliance. The process relies heavily on data collected through VAT annexes, lists of deductions and costs provided by taxpayers, and third-party information from financial institutions and customs. An extensive withholding system ensures that an important share of liabilities is remitted by third parties. The government has also implemented electronic billing to all firms except small- and medium-sized enterprises (SMEs) and independent professionals. The aim is to move towards a paperless economy. For wage-earners, tax returns are pre-filled and require only taxpayers’ approval, thus creating a default compliance mechanism.

Ecuador’s tax system has several unique features that point to areas for potential reform. Ecuador has used a tax on capital outflows (impuesto a la salida de divisas, ISD) with the objective of preserving liquidity in Ecuador’s dollarized economy by disincentivizing dollar outflows. This tax is distortive and likely reduces the productivity of firms, by discouraging investment and increasing costs. However, it has become an important source of revenues, raising 10 percent of the total tax revenue. In addition to the ISD, Ecuador’s import tariffs are very high, significantly above those of regional and structural peers. They raise 12 percent of tax revenues but increase production costs and undermine competitiveness. Ecuador also has a relatively distortive tax advances model. Ecuador’s tax advances have a sophisticated base, featuring a combination of assets, profits, and deductions. It is possible that the minimum tax advance does not correspond to a firms’ tax liability on profits, for instance. In addition, part of the tax must be paid in advance, which might reduce the liquidity of firms, particularly for small and growing firms. Moreover, there is an opportunity to level VAT rates with regional peers. There is space for increasing rates and narrowing the list of zero-rate goods, focusing on those that are actually consumed by the poor. For example, a two percentage-point increase in the VAT rate combined to a targeted elimination of VAT exemptions could yield approximately one percent of GDP in revenues after fully compensating the poor for the effect of this reform. Finally, Ecuador’s PIT schedule could benefit from more progressivity. Deductions, which benefit only the upper-income tiers, could be further reduced. Eliminating all deductions could yield up to 0.7 percent of GDP in additional revenues, for example, with no impact on the poor. On CIT, exemptions and deductions should be carefully assessed and reduced. These benefits could be substituted by more efficient compensation mechanisms such as accelerated depreciation of assets.

A successful tax reform should aim at mobilizing revenues, simplify the tax system, and reduce distortions to productive activities, while protecting the poor and vulnerable. Ecuador faces the opportunity of reviewing several features of its tax system that currently undermine efficiency and impact the economy. During this process it is critical to assess and carefully mitigate the potential adverse impacts on the poor and vulnerable. While direct taxes reach mostly the upper part of the income distribution,
indirect taxes might reach goods that are consumed by low-income individuals. Ideally, increases in such taxes, which can be necessary to collect additional revenues or compensate for reductions in distortive taxes, should be accompanied by target transfers that compensate vulnerable individuals for the impact of the increase, restoring their purchasing power.

**Improving Public Spending**

**Public Investment Management**

**Ecuador has introduced sharp cuts in public investment during recent years; the impacts of this cuts could be mitigated by ensuring that public resources invested achieve the highest social returns.** Public investment peaked at almost 18 percent of the GDP in 2013 but has gradually dropped to 6.6 percent in 2018. These adjustments have been mainly driven by the completion of large investment projects in transport, energy, health, and education. Some of those projects are still waiting to become fully operational. While in regional terms Ecuador has a relatively sound track record with respect to the implementation of projects, the country’s public investment system still faces important challenges that undermine investment performance and sustainability.

**Public gross capital formation is lower than official figures of investment would suppose, posing challenges to the design of a public investment management (PIM) system.** A closer look at the portfolio of projects suggests a loose classification of capital expenditures, i.e., it includes projects and programs that would not be defined as such according to the IMF Government Finance Statistics Manual (GFSM 2014). If the portfolio of projects is re-classified using the GFSM definition, only 51 percent of projects (in terms of value) can be considered an accumulation of physical capital. Physical capital projects amounted to 17 percent of the total number of projects implemented between 2008 and 2017, indicating that the increase was driven mainly by non-physical capital projects. These projects were mainly related to social development, knowledge generation, and human talent. A PIM system is better served by a definition of investment which equates the acquisition or significant improvement of a fixed capital asset. The value of the asset created should then appear on the balance sheet of a public-sector body upon completion.

**Public investment planning and ex-post monitoring also face shortcomings.** Ecuador’s PIM system lacks an asset management system to track public infrastructure over time. Public investment projects, whether implemented under a PPP or through more conventional means, should aim either to support the creation of viable infrastructures, such as roads, airports, and railways, or to provide social infrastructure and public services, such as hospitals and schools. It is critical to use a unified system of project identification, appraisal and, later, implementation in order to ensure consistency in the entire project life cycle.

**The weakest aspects of Ecuador PIM are in the initial and final phases of a project cycle i.e. project selection/appraisal and the ex-post monitoring and management of assets.** According to the National Development Planning Secretariat (SENPLADES), most projects presented for selection and appraisal are of low quality, suggesting the need for clear guidelines and training on that topic to project proponents. While guidelines require the inclusion of economic appraisal studies, there is no specific guidance as to the methodology that is to be followed. Moreover, guidelines follow a “one-size fits all” approach and do not specify differentiated requirements depending on the project size and complexity, and the use of thresholds above which cost benefit analyses are necessary. Between 2008 and 2018, there were a total of 10,626 projects registered as part of the annual investment plans in e-SIGEF, yet 9,627 of them (roughly
91 percent), did not include the Unique Project Code (CUP) issued by SENPLADES, which means that they are not monitored.

Ecuador would benefit from the creation of a national public investment system adequately framed in the law and specific regulations that clearly establishes the roles, responsibilities and processes throughout the project cycle. SENPLADES has issued formal guidelines and methodologies for agencies to propose and prepare projects. However, SENPLADES alone does not have the capacity to enforce the use of the guidelines and methodologies and can thus suffer from political interference. More importantly, the development of a unified framework for public investment projects should foresee the establishment of independent review processes for large infrastructure projects, including clear roles and responsibilities, to correct for potential biases that might be present in project appraisal. The lack of integration between the financial system and the investment plan limits the effective monitoring of projects during and after implementation. While SENPLADES and the Ministry of Economy and Finance (MEF) have developed information systems for project planning and preparation (SIPeIP) and budgeting processes (e-SIGEF), these are not interconnected, which implies that entities need to manually register their projects in both systems, thereby affecting the consistency and quality of the information.

Public Financial Management

**Strengthening the public financial management framework is critical to ensuring a successful fiscal consolidation.** Ecuador’s Public Financial Management (PFM) framework in Ecuador has important gaps when compared to best international practices. Multi-year planning is weak, for example. In addition, investment projects rarely consider the operational and maintenance expenses associated with the new assets. The articulation between the government’s budget, its commitments, and its payments is also weak. In the absence of fiscally consistent ceilings for the budget prior to its preparation, the MEF has to impose ex-post payment limits in order to manage liquidity. Frequent and sometimes sizable budget changes undermine its usefulness as a planning tool. The MEF can increase or reduce the approved budget within a discretionary limit of up to 15 percent without legislative approval. This flexibility has resulted in an excessive number of in-year adjustments (up to 4,000 per year), reflecting a poor level of control. Finally, there is limited budget oversight, due to the narrow coverage of audits and lack of timeliness of their reports, weak independence, and the limited transparency of internal audits.

One of the main recommendations at this stage relates to the implementation of a medium-term fiscal framework (MTFF) by: (i) developing of a comprehensive top-down approach for budget preparation emphasizing the leading role of the MEF; (ii) ensuring that budget programming is based on a comprehensive medium-term macro-fiscal scenario; (iii) improving the calendar for budget preparation so as to clarify the moments when the MTFF is updated, thereby allowing for the timely determination of

11 Final budget (presupuesto codificación) exceeded the original budget by more than 20 percent in 2016 and 2017 because of the emergency budget allocated in response to the earthquake in 2016 and the presidential transition in 2017. In an electoral year, the Budget Law permits the use of the same amounts as approved in the prior year’s budget until a new budget is prepared by the incoming administration.

12 The CGE has full discretion to undertake different types of audits and reviews to public-sector institutions. However, financial audits of line ministries are limited in scope, depth, and frequency. Moreover, audit reports and observations are normally not issued on a timely basis and lack of adequate evidence. The quality control system and the follow-up function of audit findings are also weak. Altogether, these technical deficiencies compound the effects of political scandals by further undermining the institutional credibility of the CGE.
binding annual expenditure ceilings for line entities that are anchored in solid macro-fiscal projections; and (iv) enhancing the mechanisms for monitoring of fiscal risks and budget control.

Public-Sector Wage Bill

Ecuador’s public-sector wage bill is high compared to regional and structural peers, but public-sector employment is low compared with peers, suggesting that wages are relatively high. In 2001, Ecuador’s public-sector wage bill of 5.5 percent of GDP was lower than its regional and structural peers. By 2016, the wage bill for the general government as a share of GDP had reached 10.2 percent. This put Ecuador above the levels of its structural and regional peers, and close to OECD countries. The public wage bill followed the government expansion associated with the oil boom but was also affected by labor reforms introduced during this period, which led to a compensation readjustment well above inflation. Ecuador’s public employment as a share of total employment has increased from 8 percent to 9 percent in recent years but remains below peer groups. The expansion in the number of public employees was small compared to the expansion of the wage bill. The average cost of a public employee increased on average more than 3 percent per year in real terms during this 15-year period.

Public sector workers in Ecuador receive higher salaries than comparable workers both in the private sector and in peer countries. Ecuador’s relatively high wage bill suggests that public sector workers have high salaries, something that has been reinforced by previous evidence in the region (Gasparini, 2015). In addition, Ecuador’s wage gap between the public and private sector is among the highest in the region. In 2012, the wages of Ecuador’s public sector employees were, on average, 42 percent higher than those of its private sector workers. This is substantially higher than the average for the region (22 percent). Less-skilled workers in the public sector have a larger wage premium than high-skilled workers, when compared to their private sector peers.

Narrowing the large public-private wage gaps that generate allocative inefficiencies of workers should continue to be a priority. This gap generates pressure on the private sector to match public sector salary offers. In addition, it may well reduce the pool of workers who are willing to seek employment in the private sector. Furthermore, it could possibly affect the growth of private sector firms as a result of the reduced number of workers seeking private sector employment. The need to either pay higher wages or limit employment also compromised firm growth. Higher wage premiums for unskilled workers, meanwhile, could reduce returns to education and possibly discourage human capital accumulation. Moreover, this large public-private wage premium can act as a barrier to expanding service delivery in a fiscally sustainable term. Thus, aligning public-sector wages to those in the formal private sector would not only increase governmental savings in the short term, but it would also attenuate these distortions.

The central government’s wage bill grew at an annual average rate of 1.5 percent in real terms from 2012 to 2016, despite effort to contain wages, mostly due to increasing benefit.13 This rise was influenced by two government actions: a wage freeze in 2012 and a nominal salary cut of high ranked officials in 2015. The latter brought annual fiscal savings of around US$21 million. In this same period, some workers were reclassified to higher pay categories. Base salaries and mandatory social security contributions account for around 72 percent of total personnel spending by the central government. Over

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13 Central government refers to state function (sector 111) and higher education entities (sector 112). The state function entities include judicial, electoral, transparency and control, executive, and legislative institutions.
8 percent is spent on additional remuneration – mainly 13th & 14th salaries – while 3 percent is spent on compensatory wages.\textsuperscript{14}

**Central government hiring has contributed to the wage bill dynamics.** Average annual growth in central government employment was around 2.7 percent between 2011-2015. During this period, the public-sector workforce increased by about 50,000 employees, with the majority of hiring concentrated in health, police, judiciary, education, and social protection. According to government documents, employment increases in recent years were driven by strategic priorities aimed at improving service delivery. The increases are also reflected in the government’s decision to increase annual spending on health and education by 0.5 percent of GDP, until it reaches 6 percent of GDP as mandated by the Constitution.

In the absence of reforms, Ecuador’s wage bill is expected to grow annually at around 1.2 percent in real terms on average, but combined reform efforts could generate savings over the next three to five year. Efforts were made to control the wage bill in 2019, which included cutting 36,000 positions under non-permanent contracts. The wage bill contracted 2.9 percent as a result. However, if a baseline scenario of “business as usual” is followed, it is expected to increase again in 2020. This situation shows that structural reforms are required to stabilize the public wage bill in the both short and medium term. The wage bill projections indicate that modifying the replacement rate can generate significant savings, in the order of US$558 million in three years and US$1.4 billion in five years. However, measures aimed at increasing the productivity of the public sector should also be considered. In particular, it is important to put in place mechanisms to mitigate the social impacts of unemployment and informality. In addition to fiscally motivated efforts, the government needs to invest in strategic workforce planning since evidence shows that hiring practices can substantially improve the wage bill and help contain it. The government should revise the structure of the salary scales given the important distortions that exist and their impact on productivity. In addition, it should consider revamping its human resource management systems with the aim of, among other things, improving its ability to take evidence-based decisions.

**Improving Strategic Public Procurement**

The government’s procurement of goods, works, and services totaled more than US$35.5 billion between 2013 and 2017 (an annual average of almost 9 percent of the GDP). This procurement accounted for 33 percent of total government expenditure – one of the highest rates observed among Latin American countries. This provides an excellent opportunity to improve the efficiency of public spending through lower prices and better quality. In the period 2013-2017, public works account for the largest share of government procurement (almost 34 percent of the total). The next largest share is the purchase of goods with more than 30 percent of the total. Procurement of services, meanwhile, represented 28 percent of all procurement. In 2017, however, procurement data show a different profile. On the one hand, construction works decreased substantially, although they still measured over 30 percent of the total. On the other hand, services and goods grew in importance also reaching more than 30 percent of the government’s procurement expenditure.

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\textsuperscript{14}Compensatory wages refer to additional expenditures that compensate employees for geographic and economic changes. Some compensatory changes include Gastos de Residencia, Bonificación Geográfica, Transporte.
An estimation of the potential for savings in public procurement was recently conducted based on data from 2013-2017. The results reveal several dimensions that can be leveraged directly by the government through the implementation of specific strategies or policies to impact contract prices. These variables include: quantities purchased, procurement method, bid evaluation and award time, seasonality of the purchases, rate of success of the processes, bid preparation time, and publication of tender announcement and award notification. Several variables that can only be indirectly triggered by the government can also have a significant impact of potential savings, namely: the number of bidders, the market concentration, the level of supplier specialization, the size of the suppliers, the level of concentration of the awards in procuring entities, the nationality of the supplier, and the supplier’s province of origin.

**Figure 4: Potential savings associated with strategic procurement measures.**

<table>
<thead>
<tr>
<th>Variable with impact on prices</th>
<th>Savings</th>
<th>Suggested policy or strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Directly Impacted by procurement policies or strategies</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quantity</td>
<td>7.3%</td>
<td>One main contract to supply 80% of the annual demand of goods of high volume and low complexity.</td>
</tr>
<tr>
<td>Procurement method</td>
<td>2.5%</td>
<td>(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.</td>
</tr>
<tr>
<td>Time to award a contract</td>
<td>1.3%</td>
<td>To implement electronic processes that are more dynamic and efficient to support award processing.</td>
</tr>
<tr>
<td>Seasonality</td>
<td>1%</td>
<td>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.</td>
</tr>
<tr>
<td>Bidding success ratio</td>
<td>0.5%</td>
<td>To modernize procedures and information availability for contract management, with the goal of curbing cost and schedule overruns. To train officials in charge of contract management.</td>
</tr>
<tr>
<td>Time allowed to prepare and submit bids</td>
<td>0.3%</td>
<td>To allow more reasonable time for bidders to prepare responsive bids.</td>
</tr>
<tr>
<td>Publication of bidding opportunity</td>
<td>0.3%</td>
<td>(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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable with impact on price</th>
<th>Savings</th>
<th>Suggested policy or strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indirectly Impacted by Procurement policies or strategies</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of bidders</td>
<td>2.4%</td>
<td>(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.</td>
</tr>
<tr>
<td>Market concentration</td>
<td>1.8%</td>
<td>To develop customized procurement strategies for the markets that showed highest levels of concentration, based on market competitiveness and end-user needs.</td>
</tr>
<tr>
<td>Supplier specialization</td>
<td>0.7%</td>
<td>To use competitive methods for categories where there are manufacturers.</td>
</tr>
<tr>
<td>Supplier size</td>
<td>0.5%</td>
<td>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.</td>
</tr>
<tr>
<td>Buyer concentration</td>
<td>0.2%</td>
<td>To develop a capacity building program to agencies with highest levels of concentration.</td>
</tr>
<tr>
<td>Supplier origin</td>
<td>0.2%</td>
<td>To foster participation of foreign suppliers in markets with low competition, high levels of concentration or where innovation is an important element.</td>
</tr>
<tr>
<td>Supplier province</td>
<td>0.2%</td>
<td>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.</td>
</tr>
</tbody>
</table>

The analysis identified potential savings of between US$7.3 billion and US$7.9 billion (equivalent 1.8 to 2 percent of GDP per year), which could have been achieved from 2013 to 2017 through the development and implementation of procurement strategies and policies. To achieve these savings, no changes to the existing procurement laws or regulations would be required. All that is necessary is a reengineering of existing procurement strategies. Potential savings potentials of this process are based
on two scenarios, one conservative and the other aggressive. The conservative scenario focuses on changes and improvements to the strategies and policies used to carry out procurement and bidding processes would be needed. The aggressive scenario anticipates these same strategies, plus efforts on the demand side by the government in the form of managing procurement requests and replacing products and materials.

The strategic consolidation of procurement demand presents the best opportunity to generate savings (estimated at 7.3 percent of the purchased amount). The analysis confirms that purchases in large volumes result in lower unit prices. It also shows that the government has considerable room for improvement in this area given the current level of demand fragmentation. Adopting one main purchase to supply the government’s annual demand for low complexity items would result in material savings. Even small consolidations, such as a main purchase for 30 percent of the annual demand, would result in prices that are significantly more economical.

Improvements in procurement methods can yield the second largest savings. The use of appropriate procurement methods is estimated to carry a savings potential of 2.5 percent of the total purchase: framework agreements provide the best prices and should thus become the method of choice for the procurement of high volume and low complexity goods. By increasing the use of procurement methods that rely on competitive processes and that enable demand consolidation (such as e-catalogues), the government could generate efficiency gains. It could also improve the levels of competition and transparency of its procurement processes at the same time.

Other direct variables with significant impact on purchasing prices include the efficiency of the bid evaluation and award processes and the seasonality of the purchases. More efficient processes for bid evaluation and awards (those that result in quicker turnaround times to decide and sign a contract) are associated with lower prices. This indicates that the development of electronic and simplified procedures could generate additional savings. The data reveals that seasonality is another significant aspect, with substantial influence on purchasing prices. Most notably, the purchases carried out in the final two months of the calendar year present significantly higher prices. Considering that almost 30 percent of purchases are taking place in the last quarter of the year, the government could achieve substantial savings by improving its procurement planning, especially by smoothing out demand along the calendar year to benefit from lower prices.

Several variables that can be indirectly triggered by government policies or strategies were also observed to have a significant impact on purchasing prices. The analysis confirms that the levels of competition and participation in procurement processes are critical to achieve savings. The government could save 2.4 percent of the awarded value with the increase of one additional bidder in low competition processes that currently count on just one or two bidders. Between 2013 and 2017, only 16 percent of procurement processes were carried out with three or more bidders and only 27 percent of processes had more than one bidder. Market concentration is another indirect variable with a significant impact on prices. In markets where one supplier concentrates most of the awards, for example, purchasing prices are significantly higher. Given the high levels of concentration observed in the data, this seems to be another area where specific strategies could yield major savings. An estimated 1.8 percent of the awarded value could be saved by diversifying the base of suppliers. Finally, the savings analysis also revealed additional savings could be obtained from encouraging increased participation by large firms and foreign suppliers, as well as by local firms from the same province as the procuring entity.
Rationalizing Ecuador’s generous energy subsidies is an important piece in its ongoing efficiency and equity driven fiscal reform process. Energy subsidies absorb a large amount of fiscal resources which are mostly reverted to the relatively well off. In 2018, fuel subsidies were estimated at 3.5 percent of GDP, higher than in 2017 (2 percent) despite the government’s efforts to increase prices of selected fuels. Subsidies valued at production costs appear to have been about half to three-fourths of those at opportunity costs during the period. These subsidies are paid for through government outlays and through financial losses borne by the national oil company. Subsidy spending declined significantly compared to the oil boom period, when spending on untargeted fuel subsidies (around 5 percent of GDP in 2012-2014) surpassed spending in education and social assistance combined. However, it remains a source of inefficiency and risk to commodity price fluctuations.

Subsidy spending disproportionally benefit those well-off, but its removal could affect the standards of leaving of the poor and vulnerable. While overall only 24 percent of households owned a vehicle or motorcycle, 82 percent of vehicles were owned by the top 60 percent of households. As a result, the top 60 percent received between 92 and 99 percent of the gasoline and diesel subsidies.\(^\text{15}\) Furthermore, people in the richest quintile received 91 percent of the premium gasoline subsidy, 76 percent of the diesel subsidy, and close to 60 percent of the regular gasoline subsidy (from the total allocated to households)\(^\text{16}\). While the subsidy of other energy products is less regressive, the top 20 percent of the income distribution receives more than half of the combined (direct and indirect) benefit of lower energy prices. The introduction of a reduced electricity tariff was meant to help protect Ecuador’s vulnerable populations, but a large share of resources for electricity subsidies still benefit the most well-off. The so-called ‘dignity tariff’, established in 2007, sets a tariff of US$0.04 per kilowatt-hour for poor households (well below costs). The tariff is available to residential users whose monthly consumption does not exceed 110 kWh in the Sierra, and 130 kWh in the Coast, Amazon and Insular Regions. More than 2.5 million residential customers (out of 4.1 million) are eligible to receive the tariffs, including many individuals with more than one residence.

Ecuador should continue pursuing a well-designed energy subsidy reform. In December 2018, the government eliminated subsidies for premium gasoline and diesel for industrial use by mandating that the prices for these products be set to match production costs and granted price setting responsibilities to the hydrocarbon regulatory agency (ARCH). These initial efforts, which are expected to result in estimated savings of approximately 0.4 percent of GDP, focused on products that have minimum to no impact on the poor and vulnerable. As the government proceeds with the elimination of subsidies in other energy products, it is important to take into account and prepare a reform package that takes into account multiple aspects including to allow cost/market based mechanisms to drive prices, liberalize and increase efficiency in energy sectors, design adequate mechanisms to compensate the poor and vulnerable for the impact of these reforms, carry out intensive consultation and develop a strategic communication strategy to minimize political backlash against the reforms.

\(^\text{15}\) 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 World Bank (2017), Ecuador: Analysis of energy pricing policies and their distributional impact, Washington, DC.

\(^\text{16}\) Results based on the most recent household income and expenditure survey, ENIGHUR (Encuesta Nacional de Ingresos y Gastos de Hogares Urbanos y Rurales) dataset from 2012.
The efficient use of public investments on education constitutes a major policy challenge in Ecuador. In the past decades, average expenditure on basic education has oscillated between 2.4 and 2.6 percent of GDP. Over this period, Ecuador made significant progress towards achieving universal access in primary and secondary education, while improving overall education quality. Indeed, Ecuador stands out as one of the countries in Latin America and the Caribbean that uses its limited resources most efficiently in support of basic education. Despite all these achievements, however, the country still has important efficiency gaps across school districts, especially when it comes to its capacity to ensure that students learn. Ecuador will need to maintain and sustain the progress achieved by the education sector in the past decades within a context of limited fiscal resources. As such, its education system will need to do more with less resources. The analysis of education spending indicates that there is still scope for school districts in Ecuador to achieve better education results without additional resources. Results indicate that school districts could improve by 10 to 15 percent their capacity to ensure student learning (as proxied by results in the Ser Bachiller learning assessment) with the resources at hand.

The government may consider achieving a better balance between investments in basic and higher education. Ecuador spends a very high share of its education budget on higher education (55 percent). This rate is much higher when compared to regional and structural peers (at 20-25 percent). Traditionally, countries spend a larger share of their budget on basic education because investments on primary and secondary education yield the highest social returns. As such, spending on basic education is usually the priority for public spending on education in countries that have yet to achieve near universal enrollment in basic education (such as Ecuador). Investments in higher education generally accrue to the richest segments of the population. This is largely true in Ecuador, where most of the students enrolled in public higher education belong to the highest income quintiles – making spending on the higher education sector highly regressive. At the same time, the levels of per-pupil expenditures in primary and secondary education in Ecuador are very low for international standards (two and five times smaller than those of regional peers, respectively). Achieving a better balance in public investments between basic and higher education seems of extreme urgency for Ecuador. This is confirmed by the fact that results from standardized tests (TERCE, 2013) reveal that only 36 percent of all sixth-grade students in Ecuador could infer, deduct, and analyze information in a written text (compared to 47 percent in Latin America and the Caribbean, on average). The results for Mathematics showed that half of all Ecuadorian students in the sixth grade could only perform simple arithmetic operations but were not capable of resolving simple math problems that require analysis/interpretation of charts, solving equations, and/or involve geometry. These results are quite important, given the fact that seven out of every ten individuals in Ecuador will only attain basic education prior to entering the labor force.

Restoring Competitiveness

Ecuador faces an external position that is weaker than the level consistent with medium-term fundamentals, including the appreciation of the US dollar vis-à-vis trading partners. Strong domestic demand contributed to an increase in domestic prices during the commodity boom. Inflation, which averaged 2.7 percent in the first half of the boom (2003-2007), increased to an average of 4.7 percent per year in the 2008-2014 period. Estimates suggest a real effective exchange rate overvaluation of approximately 20 percent by 2014. In 2015, the average real exchange rate appreciated a further 14
percent in response to a substantial appreciation in the U.S. dollar. Ecuador’s regulatory framework and policy choices contribute to these dynamics. For example, growing public employment with a wage premium led to a sharp increase in labor costs; the real median wage increased on average 3.9 percent per year during this period. Efforts to incentivize import substitution, such as higher import tariff rates and non-tariff barriers, also increased the cost of intermediary goods, including agriculture products. These policies undermined Ecuador’s ability to compete internationally, intensifying the symptoms of Dutch disease.

**Figure 5: Minimum wage vs value added per worker**

![Chart showing minimum wage vs value added per worker](image)

**Figure 6: The Real Effective Exchange Rate**

![Chart showing real effective exchange rate](image)

**External imbalances in Ecuador’s dollarized economy, partially reflects the inability of prices and costs to adjust to changes in the external environment.** While Ecuador has faced a mild deflation in the past year, a large set of prices are fixed, or cannot decline by regulation, which limits the pace of adjustment. Those include labor costs, utility and energy prices, financial costs, price of agricultural products among others. Rigid prices and regulations contribute to the distortion of relative prices and misallocation. Relatively large and persistent differences in total factor productivity (TFP) between firms (within the same sector) suggest that constraints prevent factors of production from moving toward more productive uses, thereby limiting productivity and competitiveness.

**The development of a competitive private sector will require well-functioning market where prices and quantity are able to adjust to changing conditions.** This process will inevitably require reforming Ecuador’s rigid regulations and price controls to the needs of its new economic model. Reforms to inputs markets, including labor and capital/financial markets are likely to have a broader impact and enable a quicker pace of price adjustment. At the same time, reducing distortions in the agricultural sector, could help unleash non-oil exports and further support the external rebalancing. This section discusses the main distortion and present reform option for these three critical segments.

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17 Ecuador SCD
Labor Market Regulations

Labor costs in Ecuador have increased over the last twelve years, while labor productivity has not improved, resulting in a loss of competitiveness relative to other countries in the region. Between 2014 and 2017, the ratio of wages to GDP increase from 0.50 to 0.57. This means that labor costs rose faster than labor productivity, increasing the relative cost per unit of labor. Ecuador’s experience contrasts with those of regional and dollarized peers, where the ratio of wages to average productivity declined over the same period. The country’s economic slowdown was not accompanied by a downward adjustment in formal wages. Indeed, formal wages continued to increase after the fall in oil prices. Ecuador’s competitiveness in relation to its peers was seriously impacted during this recent period.

Ecuador’s formal wage dynamics were largely driven by the minimum wage, which is relatively high compared to other countries in the region. Between 2006 and 2017, the share of the minimum wage to the average wage of formal workers increased from 40 percent to 50 percent. This share was ten percentage points was higher than for regional peers on average in 2017. The reason is that Ecuador’s minimum wage is higher and grew at a faster rate than in peer countries. Increases in the minimum wage, as occurred in Ecuador, not only affect labor costs and firms’ competitiveness, they also have an adverse effect on formal employment for individuals at the bottom of the wage ladder, such as young and unskilled workers, contributing to informality.

In Ecuador, wage setting for the private sector is determined by the Basic Unified Minimum Wage, which includes a national minimum wage and minimum wages by sector and occupation. Minimum wages are decided through a bargaining process between workers, employers, and government representatives at the end of each year. If no agreement is reached in the negotiation process, which is usually the case, minimum wages are set by the Ministry of Labor. Once the national minimum wage is determined, the Sectoral Wage Councils meet to decide increases of sectoral minimum wages, including minimum wages by occupations within each sector. These councils convene worker representatives, private-sector employers, and the government. There are 22 councils in total, although the number has been known to change (Wong 2019). Sectoral minimum wages can differ widely for similar occupations, thereby creating distortions in the labor market. For instance, the minimum wage for a manager in the telecommunications sector is 4.4 times higher than that of his or her peer working in finance. Public wage increases have also added pressure to the salary scale. As a result, the minimum wage structure in the economy does not reflect differences in productivity either within or across firms. This uncompetitive wage-setting mechanism directly affects the private sector’s ability to adjust and compete.

In Ecuador, the average cost of complying with labor regulations (i.e. non-wage costs) is higher than for most of its peer countries. The non-wage costs associated with ensuring compliance with labor regulations include mandatory contributions, bonus payments, annual leave, severance payment, and firing notice (Alaimo et al. 2017). Total non-wage costs in Ecuador account for 2.3 percent of GDP per worker, which is 0.6 percent above the average in Latin America. Most of the non-wage cost as a share of...

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18 Ecuador Trade, Investment, and Competitiveness Report
19 Wages for the economy as a whole might have adjusted partially in light of worker migration from the formal to the informal sector.
20 India, South Africa, and Uruguay are countries with a similar wage structure to Ecuador.
21 This data was taken from (Alaimo, Bosch and Gualavisi 2017) which is the most recent study of labor cost in Latin America. Wage and non-wage structure of labor are computed revising legislation in most Latin American for 2013.
GDP per worker is determined by mandatory contributions (1.2 percent) and bonuses (0.6 percent). It is worth noting that the cost of complying with labor regulations as a share of GDP per worker in Ecuador is similar to the cost in Argentina, Brazil and Colombia. Chile has the lowest cost of compliance and is also the country with the most flexible labor market in the region. Notably in the case of Ecuador, non-wage mandatory contributions are computed as a fixed rate of wages. This makes non-wage costs increase at the same rate as wages, which goes a long way to explaining the country’s rising cost of labor over the last two decades. Reducing the cost of regulatory compliance could significantly improve Ecuador’s labor market outcomes.

**Regulatory rigidities design to protect jobs limits labor mobility towards more productive use.** Labor legislation and constitutional constraints forbid several contract modalities, limiting the flexibility of the labor market. In 2008, the Constitutional Assembly banned hourly contracts, as well as intermediation and outsourcing. The move was designed to prevent the negative impact of such employment mechanisms on working conditions and labor stability. Contracting workers through a third-party service provider (outsourcing) is only permitted in the case of four complementary services: security, catering, delivery, and cleaning. In 2015, the Law for Labor Justice imposed additional constraints by banning fixed-term employment contracts that allowed employers to hire a worker for one year with the possibility of renewing the contract for another year. Such contracts made workers vulnerable to being fired at any time without any compensation. The law also reduced the probation from 12 months to 90 days. Regional peers (excluding Chile and Colombia) also prohibit firms from imposing fixed-term contracts for permanent tasks. Such contracts are allowed for non-permanent tasks, however. Ecuador also has the highest dismissal cost of workers in Latin America. Severance payments for a worker with five years of tenure is twice as high as the Latin American average and 1.52 higher than the average for regionals peers (Doing Business 2019). Ecuador’s Labor Code obliges employers to pay a severance bonus whenever an employment relationship ends, even in the event of the worker resigning. The size of the severance payment is 25 percent of the worker’s last monthly wage for each year of service. When a dismissal occurs without a justified cause, severance payments also include a compensation equivalent. For those that have worked more than three years, they are entitled to one month of salary per year of service, up to a maximum of 25 monthly wages. This implies that compensation for dismissal increases with the duration of services.

**Revising Ecuador’s labor market regulations is essential to grant firms the ability to adjust and compete, while still ensuring works are protected.** First, Ecuador needs to completely reform the structure of its minimum wage and the mechanism for setting it. The process must be simplified and must relate more closely to changes in the average productivity per worker. An initial reform could be to modify the inefficient structure of wages by sector and occupation to a structure that considers workers’ skill levels. It is also important to reinstate hourly contracts, at least for young workers, thereby giving firms flexibility to generate formal jobs. The primary challenge with this reform is learning from the past and having clear rules that protect workers when implementing these types of contracts. Constitution reforms are needed and will not be implemented in the short term. Still, it is possible to add flexibility to labor markets,

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22 Current labor legislation allows some forms of contracts that are similar to a fixed-term employment. These include: piecework contracts for specific work that is part of the course of the business; incidental contracts for satisfying an employer’s special demands (e.g. replacing personnel on leave); casual contracts for attending to urgent or special needs not related to the employer’s regular business up to 30 days; days-in-a-year contracts; and contracts on a job-by-job basis.
including through term contracts, without modifying the Constitution. A first step should be reducing the cost of dismissal for firms, for example, by excluding from severance payments for workers that resign voluntarily from their jobs. As regulations become more flexible it is important to redesign the structure of unemployment insurance to ensure workers are protected during transition. The application process should be simplified and access should be opened up to independent workers on similar terms as for formal workers.

Financial Sector

**Improved financial sector performance benefits private investment and innovation.** The lack of access to finance is considered by business to represent an important obstacle to investment and innovation, as discussed further below. The use of banks by Ecuadorian firms to finance investments is lower than average for the region and for similar income country groups, while access to long-term finance is low even among large companies. Regulatory barriers, segmentation, and inadequate supervision limit financial sector performance. The private credit to GDP ratio is only 29 percent in Ecuador versus 47 percent in Colombia, 36 percent in Peru, and 49 percent on average for LAC. Those estimates combine credits provided by commercial banks (approximately 50 percent of financial assets), public banks (approximately 32 percent of financial assets), and the large cooperative sector (approximately 16 percent). Finally, capital markets are underdeveloped compared to neighbors such as Peru and Colombia, with limited participation of institutional investors. This is particularly true for private pension funds, which allocate an important share of their portfolio to government bonds.

**Commercial Banks account for half of the assets in the financial sector.** As shown in Table 1, the financial sector manages assets for approximately US$81 billion. Privately owned commercial banks manage assets for US$40 billion, and public banks—including the Investment Bank of the Social Security, BIESS—manage assets for US$26.5 billion. In other words, the presence of the public sector is significant in the domestic financial sector. While they participate in similar market segments, public banks have some regulatory and supervisory waivers, including liquidity requirements. The presence of international banks is small, and large banks belong to domestic financial groups. With 608 institutions, cooperatives manage assets equivalent to approximately one third of the assets of the commercial banks. While banks are supervised by the Superintendence of Banks, cooperatives are supervised by the Superintendence of Economía Popular y Solidaria.

**Table 1: Financial System in Ecuador**  
(December 2018)

<table>
<thead>
<tr>
<th>Assets (US$ million)</th>
<th>Number of institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>40,983</td>
</tr>
<tr>
<td>Public Banks</td>
<td>8,093</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>13,034</td>
</tr>
<tr>
<td>Mutualists</td>
<td>982</td>
</tr>
<tr>
<td>Closed Pension Funds</td>
<td>1</td>
</tr>
</tbody>
</table>
Commercial banks are focused in corporate and consumption market segments. Commercial banks’ lending portfolio as of end of 2018 was US$25 billion, of which half of it was allocated to corporate lending and other 40 percent to household lending. In the absence of long-term sources of funding; lack of a capital market to offload the mortgage portfolios; and the presence of a strong competitor in the public sector (BIESS), only 10 percent of the lending portfolio of commercial banks is allocated to mortgages. Government sponsored programs for the participation of commercial banks have temporarily increased their interest, but the increases in their lending have been offset by decreases in the lending portfolio of the BIES.

Public banks have strong presence in various sectors of the economy. Ecuador has three public banks, one public agency that act as a second-tier bank for cooperatives, and one public investment bank that manages the resources of the Social Security System. The Corporacion Nacional de Finanzas Populares y Solidarias (Conafips) and BanEcuador focus on consumption and microfinance segments; Corporacion Financiera Nacional (CFN) focuses on SMEs and corporate segments; Banco de Desarrollo del Ecuador (BDE) in supporting infrastructure projects and subnational governments; and BIES in supporting Social Security beneficiaries in the segments of consumption and housing. There is some overlap in the segments served by commercial banks and public banks, and commercial banks provide—by regulation—a significant part of the funding for public banks. BIES is a strong competitor in the household segment of the market, and it targets clients from the formal sector. Public banks are not required to follow financial performance requirements and some of them receive direct financing from the deposit insurance fund.

The financial sector is stable, but the divergence between credit and deposit growth warrants continued vigilance. Banking sector indicators appear adequate, with the ratio of capital to risk-weighted assets at 13.2 percent, non-performing loans at 3 percent of total loans, and liquid assets at 25 percent of short-term liabilities, but liquidity conditions are tightening. Financial sector credit growth remains in double digits, driven by consumption and microcredit, the most profitable and short-term segments, thus potentially creating conditions for balance of payments (BOP) pressures. In contrast, deposit growth has remained weak (5 percent y-o-y). New credit has been funded in part by running down foreign assets and increasing external funding (net foreign assets of other depository institutions declined by 16 percent y-o-y in April 2019). Credit and deposit growth in the cooperative sector are more balanced but outpaced growth in the private banks.

The large participation of the government in the economy imposes a significant risk on the financial sector, as government risk is one of the main underlying risks faced by the financial sector. A potential slowdown of the economy may jeopardize the solvency of several financial institutions that directly or indirectly depend on the government. The stress testing on the cooperative sector gives an initial indication of the vulnerabilities of this specific sector of the economy. The reluctance of the commercial banking sector to provide additional lending to the government is also explained by this factor.
Ecuador’s financial sector is not conducive to an efficient allocation of resources. While the current architecture of the financial sector has been able to channel credit to different sectors of the economy, it has done so at a high fiscal cost. In addition, it has transferred risks to smaller financial institutions and reduced the strength of institutions such as the Central Bank and the deposit insurance.

Existing liquidity requirements for the banking sector represent a significant burden for intermediation. In addition to traditional reserve requirements (segmented by bank size) and the contributions to the liquidity fund, regulation requires: (i) a minimum liquidity requirement that establishes specific minimum percentages of liquid assets to be held, and (ii) a floor on balances that must be held in domestically issued instruments. The latter imply significant obligations to hold government and public bank-issued paper. This requirement reduce liquidity available for credit allocation and create a captive demand for bonds of the government and public banks, allowing these institutions to access funding at artificially low rates.

All lending interest rates are controlled through interest rate ceilings. These ceilings were initially set to prevent abusive intermediation rates, but they have been constant for several years and are disconnected from market fluctuations, contributing to a misallocation of resources. This misallocation is reflected in the fact that individuals and companies can access financing at a cost below the government’s cost of funding abroad. This is possible due to the artificially low funding in domestic markets, which is reflect in the cheap funding for public banks and cooperatives (which are partially funded by a second tier public bank). For example, it is common for deposit rates in the cooperative sector to be higher than the mortgage lending rates offered by public banks or lending rates applicable to SME financing. There is evidence that interest rate ceilings make commercial banks cautious about lending to certain segments of the economy. The lack of financial compensation for the risks that they take discourage banks from pursuing risky clients, such as SMEs. As it relies excessively on internal models provisioning regulation for commercial banks needs to be revised in order to ensure that banks are properly pricing the risks they take.

Interest rate ceilings affect medium and smaller commercial banks more than larger ones, hurting competition. Larger commercial banks are the ones that can better manage these risks. In fact, larger banks have been profitable and able to gain market shares over time in several segments of the market. They have better capacity to price risks and their wide distribution capacity allow them to have a low cost of funding, supported by their depository base. Medium and smaller banks face more challenges to generate a sustainable business, not only because of their higher cost of funding, but also from the unfair competition from other financial institutions, such as cooperatives and public banks. While commercial banks in March 2019 earned an annualized return on equity (ROE) of 12 percent, smaller banks showed high dispersion in their returns, and low ROEs compared with the rest of the industry.

Differences in regulatory and supervisory requirements for commercial banks, public banks, and cooperatives, add to the differences in funding costs, and create an unlevel plain field. While public banks are supervised by the Superintendence of Banks, the level of enforcement is different from that of commercial banks. Within the Superintendence, bank supervision is divided between public and commercial bank units. While the same capital requirements and provisions apply to both public and commercial banks, the level of enforcement is different for the two types of banks. Liquidity requirements

23While a ROE in the range of 12 percent may look attractive, as a reference, an international investor may get a return of 10.75 percent simply by investing in an Ecuadorian sovereign bond, assuming only the government credit risk.
are different for public and commercial banks. The regulatory approach has taken the position that public banks should fill the gap in those sectors of the economy that have been underserved by the commercial banks and should be less restricted to do so. However, this approach reinforces and amplifies gaps between the two segments.

The cooperative sector has been growing rapidly in the past few years and is a strong competitor for the banking system in segments of households and microfinance; the sector has taken a significant market share of total deposits in the financial system. Cooperatives are subject to a weaker regulatory framework that allows them to be more aggressive than commercial banks in their deposit and lending rates. The cooperative sector has lower standards of prudential regulation as compared with commercial banks (and also compared to best practices); differentiated provisions over time, which depend on the size of the cooperative; reserves that are financed with a mandatory contribution (these reserves are taken from lending); differentiated capital requirements during a long transition, less than best practices with an adjustment calendar until 2027, and ad-hoc methodologies for accounting non-performing loans.

Because of weaker regulations the cooperative system has been accumulating risks. The largest cooperatives in Ecuador have significant shortages of provisions and may need significant capital injections to cope with some relatively mild stress test scenarios. The situation is worrisome for the smaller cooperatives. It is essential to take measures to strengthen their provisions and capital in order to ensure that they are prepared to compete with the banking sector on a level playing field.

Strengthening the capital structure of banks and reducing the unfair competition from cooperatives and public banks are necessary steps for building a sound financial system. Banking regulation needs to be upgraded to Basel III, and the levels of credit risk and liquidity risk analysis need to improve. This effort should be accompanied by enhancing the supervisory capacity at the Superintendence of Banks and macro monitoring.

Strengthening financial sector performance and allowing for an efficient allocation of financial resources will require removing the numerous distortions describe above. The first step is to correct distortions on lending rates and funding costs, allowing prices to reflect market conditions. This could be done gradually by making lending ceiling flexible and subjected to market fluctuations, while strategically phasing them out of different marked segments, starting with the corporate sector. Gradually removing regulatory requirements that allow for below market domestic financing and inhibit domestic bond market developments is also a pressing need. This process should be accompanied by a redefinition of the functions of public banks, switching their functions toward a complementary role, with emphasis on leveraging (rather than substituting) financing from private sector sources. Finally, the alignment regulations and supervision standards should be accompanied by efforts to mitigate risks arising from the cooperative sector. Cooperatives should be consolidated and capitalized, but the resources of the Deposit Insurance should not be considered in the process of capitalization. One alternative would be to create a government fund to support those cooperatives that are financially viable and develop a strategy to limit possible contagion. Bringing cooperatives in Segment 1 under the supervisory framework of the Superintendence of Banks would be a quick way of improving the regulatory standards of this segment of the market, which has 75 percent of the assets of the cooperative sector.

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24 Segments 1 to 3
25 Due to data availability, it was not possible to conduct the analysis for cooperatives of segments 4 and 5.
The set of financial sector reforms would need to be conducted on a gradual basis in order to avoid sudden increases in interest rate that may jeopardize economic growth benefits or destabilize the financial position of individuals or firms. Although in the context of reforms of public banks it is expected that commercial banks may partially replace their role, it is important to ensure that the most vulnerable sectors of the population continue to be protected.

Agriculture Price Support Policies

Ecuador’s system of agricultural incentives is currently under debate, with particular focus on minimum price support (MPS) and import quotas. Producer supports of this form include not only MPS, but also import quotas and tariffs. These all distort markets. Not only do they prevent the competitiveness of downstream industries, they also create perverse incentives for farmers to increase production of food groups for which they lack comparative advantage. Evidence suggests that MPS limits the competitiveness of high-value exportable commodities and of certain agro-industrial value chains, the burden of which is transferred to local consumers. These policies consist of setting a price floor applicable to all producers of selected agriculture products (including, corn, rice, milk, banana). By guaranteeing above-market prices, MPS typically promotes overproduction, requiring governments to purchase and store the oversupply, which effectively acts as a tax on consumers and intermediary purchasers. Contrary to expectations, it is not the poorest who benefits the most from this type of policy, as this segment tends to produce less than it needs.

In 2014, the government changed its MPS policy, with the result that support for producers increased significantly and the indirect benefits previously enjoyed by consumers decreased, albeit with important differences across food groups. Estimates from the Ministry of Agriculture show the evolution of the reference prices at international level and the prices paid to producers. When the difference is negative, it implies consumers are benefitting from governmental decisions; a positive difference, in contrast, indicates that farmers are receiving support that exceeds the equilibrium market price. Both strategies tend to generate distortions within the market. In the case of rice, for example, support for producers has increased constantly in recent years, rising from US$33.9 per ton in 2013 to US$153 per ton in 2016.

Government aid for producers via MSP has risen steadily since 2011, especially for milk. In all cases, the value of support increased significantly since the government’s MSP policy shifted from being a consumer-focused support to a producer-oriented support. The value of government aid represents the difference between the producer price and reference price. This is calculated from 2011 (when government policy changed) to 2016 (the most recent year for which data are available). The year 2011 also serves as a baseline reference because it precedes the initial year (i.e. 2012) for which production and sales’ figures are collected for this analysis. Evolution of aid for bananas producers is exempted from this calculation given the neutral nature of the aid provided.

Exports of rice, corn, and maize have contracted significantly over recent years, despite a relatively stable level of domestic production. This phenomenon is seemingly related to the government’s decision
to distort the market by increasing the “internal” support for producers who were selling their products using resources stemming from the government and Ecuadorian consumers (rather than relying on the external market). The opposite tendency can be seen with banana producers, who received neutral aid from the government and whose export volumes increased continually and significantly during the same time period.\(^{26}\) The overall impact on Ecuador’s trade balance associated with these policies also merits attention. Increases in public aid correlate with a fall in import volumes. The relative importance of product imports decreases in line with a rise of direct support to products. This is evident in the case of rice, for instance. Imports of this staple commodity dropped in 2013 and 2014 just when direct transfers and price support increased. For maize, meanwhile, the years 2015 and 2016 witnessed a reduction in direct transfers. Over this same period, imports increased. This marked a departure from the trend over previous years, during which maize imports were consistently decreasing.

**Benchmarking against international experience of eliminating “coupled” payments such as MPS and moving towards “decoupled” payments to farmers, we find several examples of successful promotion of the latter to boost competitiveness of local economies.** New Zealand provides a case in point. In the mid-1980s, for example, New Zealand’s government started abolishing MPS on wool, beef, sheep meat, and dairy products. It reduced and/or removed tax concessions, land development loans, and subsidies for fertilizers and irrigation, among other measures. By 1989, the Producer Support Estimate had consequently decreased to 3 percent (down from 24 percent in 1979). The result was a clear shift from quantity to quality. On the one hand, the number of New Zealand’s sheep and beef farms fell by nearly one third (31 percent) over a two-decade period. On the other hand, average carcass weights increased 25 percent. There was also an increase in the size of farmers’ herds during this period as well as a rise in dairy production (of 75 percent). By the early 2000s, export revenues from lamb and sheep a important demonstrated an increase and productivity levels in the agricultural sector were three times higher than the average of the economy as a whole.

**Ecuador has recently taken measures to diversify into novel export-oriented agricultural products, such as quinoa, plantains, dragon fruits (pitahayas), malangas, avocados among others, but price controls and distortions discourage this process.** Achieving global competitiveness for these crops will entail understanding how to structure alternative, decoupled agricultural supports and incentives that do not discourage productivity gains and reallocation. Here, lessons from New Zealand, the EU, and other regional counterparts such as Brazil and Uruguay are useful. Policies and reforms should aim at encouraging a transition to productive crops, upgraded technologies, and how to adapt incentives for climate smart agriculture. The protection of subsistence farms should be done in a target and non-distortive manner.

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\(^{26}\) The data available for this study point to a correlation between export levels and producers’ receipt of price support and direct transfers; they are agnostic as to whether a causal relationship exists between the two.
Invigorating private sector investment, trade, and employment generation

The internationalization of the Ecuadorian economy is necessary if the country is to successfully adopt a development model led by the private-sector. Connection to international markets through exports, imports, Foreign Direct Investment (FDI), and Global Value Chains (GVCs) is paramount. This will allow Ecuador to expand market opportunities for local enterprises as well as increase their productivity. The country will also stand to benefit from the efficient reallocation of factors of production in the economy. Ultimately, all of these elements together promise to foster future economic growth. By exposing companies to fierce competition in international market, exports tend to push domestic firms to specialize and, in turn, to improve their operations and production processes. Imports, meanwhile, allow firms and consumers to access high-quality inputs and final products that may not be available locally or that may be overly expensive. FDI firms create jobs as well as bring frontier technology and know-how that could potentially be transmitted to the host economy, thereby increasing the productivity of local firms. Nevertheless, these policies and transitions should be managed carefully, in coordination with fiscal and structural reforms to improve factor and input markets. This would create the necessary conditions for domestic firms’ conditions to compete and benefit from this integration.

Status of International Integration

Trade Performance

Ecuador is relatively closed to foreign investment and international trade. The stock of FDI-to-GDP and the trade-to-GDP ratios are two of the most basic indicators of integration to global markets. The former ratio evaluates the role of external capital in the economy. The latter ratio combines the importance of exports and imports in an economy. It also indicates the importance of foreign demand for domestic producers, on the one hand, and of foreign supply for domestic consumers and producers, on the other. When compared to countries with similar per capita income, Ecuador is well below its potential for both ratios. The stock of investment as a share of Ecuador’s GDP, for example, is the lowest within its comparator nations and well below the potential curve. Its score for trade openness, meanwhile, is similar to that of Peru, but lower than that of Chile or Romania (Figure 7).

Figure 7: Benchmarking Ecuador’s Integration into Global Markets (2014-2017)

<table>
<thead>
<tr>
<th>Stock of FDI</th>
<th>Trade Openness</th>
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</thead>
</table>
Note: These figures benchmark Ecuador trade openness and the stock of FDI with respect to all countries in the world. Each dot in the figure indicates a country. The dotted line represents the expected value of each indicator for a given per capita income, controlling for GDP per capita and GDP per capita squared. The gray area is the 95 percent confidence interval. Ecuador and some regional peers are identified by the ISO codes. Source: Authors’ computation using data from the World Development Indicators and UNCTAD.

Inward looking policies applied during the commodity boom created important hurdles to connecting with the global economy. The most important competitiveness challenges related to diversifying away from oil exports, expanding access to imports, specially of intermediary and capital goods, attracting foreign direct investment (FDI), and inserting itself into strategic global value chain than enable technological upgrading and productivity gains.

Exports upgrade and diversification is a key challenge: Ecuador’s high concentration of exports around a few products with low value added or natural resources makes the country vulnerable to fluctuations in international prices. In comparison with relatively similar countries, Ecuador has fewer exporters, lower entry rate of firms into exporting, larger firms upon entry, and higher survival rates. These facts indicate disproportionally high fixed costs to export in Ecuador when compared with similar countries. A direct relationship exists between firm-level productivity and the fixed costs to export. In light of this, it is notable the relatively few firms in Ecuador that export tend to have better outcomes (size and survival) than firms in similar countries. This indicates that firms in Ecuador need to be relatively more productive in order to afford the relatively high export costs that they face. Some of the factors increasing the cost to export are discussed below.

Figure 8: Technological Classification of Exports (2017)  
Figure 9: No Oil-export Sophistications (EXPY-2017)
Import restrictions have resulted in increasing cost for Ecuadorean firms, including those who target exporting markets: During the last decade, Ecuador’s import performance has broadly followed the international oil price cycle. To keep the trade deficit in check when oil prices dropped, the government implemented a range of interventions to curb imports. This reduced the ability of firms to access imported inputs in a stable and predictable manner, the impact of which was felt particularly by those either seeking to connect to regional value chains or those already connected. Ecuador’s share of capital imports has been consistently declining since 2012 as a result of the government’s interventionist measures.

Recent FDI dynamics

Restrictive policies and contract enforcement risks discouraged FDI during the commodity boom, placing Ecuador at the bottom of the region with respect to attracting FDI. The development model prevalent during the last decade has prioritized public investment over private investment. Between 2005-2015, flows of FDI accounted for less than 1 percent of GDP. This compares to an average rate of 3-7 percent for neighboring countries. Foreign investors in Ecuador are heavily concentrated in the extractive sector, which limits knowledge transfers from multinational corporations to the local economy. Recently, however, FDI flows have started expanding into other sectors, such as business services, retail and wholesale, and agriculture. Even so, the overall stock of FDI in the country remains low.

Figure 10: FDI Inflows (% GDP)  
Figure 11: Stock of FDI (US$ millions)
Note: This figure shows the flows of FDI (as a share of GDP) received by Colombia, Peru, Ecuador, and the region.
Source: Authors’ calculation using information from the World Development Indicators.

Note: This figure shows the stock of FDI in US$ millions in Ecuador, Peru, and Colombia.
Source: Authors’ calculation using information from the World Development Indicators.

Connection to Global Value Chains

Ecuador’s connection to regional or global value chains (GVC) is limited. The degree of participation in GVCs is below that of Chile, Peru, and Mexico. Over the last decade, Ecuador’s import substitution policy has increased the domestic value added embedded in the country’s gross exports. This has occurred at the expense of using foreign inputs that could have allowed the country to connect with international production chains. As a result, Ecuador is now located upstream in the GVCs in which it participates, indicating its specialization in primary products with low value added.

Table 2: Competitiveness Challenges for Global Integration in Ecuador

<table>
<thead>
<tr>
<th>Channels</th>
<th>Key Challenges</th>
</tr>
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</table>
| **Exports** | 1. High concentration of exports around a few products with low value added that makes the country vulnerable to abrupt changes in international prices.  
2. Disproportionally high fixed costs to export, as evinced by the small number of exporters, the low entry rates, and the relatively larger size of exporters upon entry.  
3. Barriers to growth for medium-size exporters due to high variable costs to export, as indicated by the low concentration of export value across exporters.  
4. Absence of wage differences between exporters and non-exporters, despite the former showing better outcomes in terms of size, investment, and productivity – a phenomenon that contradicts international evidence and indicates important friction in the labor market. |
### Imports

1. During the last decade, import performance has broadly followed the oil price cycle. Changes in imports responded to government interventions to maintain a low trade deficit rather than reacting to market forces.
2. Imports of capital products, which are important for increasing the productivity of local firms, are relatively low.

### Foreign Direct Investment

1. The country has lost competitiveness in attracting FDI over the last decade. Between 2005-2015, annual flows typically accounted for less than 1 percent of GDP. This fact reflects a growth model based on public expenditure that crowded out private investment.
2. A sustained disinvestment of U.S. multinational corporations operating in the country over the period 2005-2015 contributed to the reduction of the stock of FDI.
3. FDI is mostly targeted at the natural resources sector. Investments directed towards the domestic market or towards GVC connections (efficiency-seeking FDI) are minor.

### Global Value Chains

1. The share of domestic value added in gross exports grew during 2005-2015 and is currently one of the highest in the region. This fact may reflect Ecuadorian firms’ difficulty in joining GVCs due to the country’s import substitution policy.
2. The degree of Ecuador’s participation is below that of Chile, Peru, and Mexico.
3. Ecuador is located upstream in the GVCs in which it participates, indicating the country’s specialization in primary products.

While a wide range of factors have contributed to increasing the cost for Ecuadorian firms looking to connect to international markets, this section analyzes the institutional arrangements and outward-oriented policy options that will foster the international integration of Ecuador’s economy. This analysis complements critical flexibilization reforms proposed in the previous section in the process of restoring competitiveness and reducing external imbalances in the Ecuadorian economy. It focused on the development of an adequate institutional framework for trade and for investment policy and promotion and on the transition to a modern trade policy standpoint.

**Institutional framework for trade and for investment policy and promotion**

The quality of the institutional framework for trade and investment has a direct effect on the coherence of policy direction, formulation, and implementation, as well as an indirect effect on policy outcomes. For any country looking to successfully integrate into global markets, therefore, an institutional arrangement that is aligned, well-coordinated, and effective is essential. To arrive at this point requires clear vision, commitment, and action-oriented leadership on the part of the government. When such conditions are in place, it is then possible to convert a set of government agencies into an articulate and high-performing institutional cluster that is capable of leveraging international trade and FDI in order to foster economic growth and diversification.

The recent reorganization and consolidation of the government’s ministries working in the areas of production, trade, and investment make an institutional diagnostic timely. A reshuffling of functions and institutional changes in the foreign trade and investment landscape has been frequent over the last decade. However, a major departure from previous practice occurred in September 2018 with the
creation of an umbrella ministry – the Ministry of Production, Foreign Trade, Investment and Fisheries, consolidating of three different ministries and one decentralized institution. The new ministry has four vice-ministries that have been assigned to address the organization’s different functions:

- Vice-ministry of Production and Industry (*Viceministerio de Produccion e Industrias*)
- Vice-ministry of Foreign Trade (*Viceministerio de Comercio Exterior*)
- Vice-ministry of Export and Investment Promotion (*Viceministerio de Promoción de Exportaciones e Inversiones*)
- Vice-ministry of Aquaculture and Fisheries (*Viceministerio de Acuacultura y Pesca*)

Core trade and investment-related functions are distributed between the Vice-Minister of Foreign Trade and the Vice-Minister of Export and Investment Promotion. The Vice-Ministry of Foreign Trade carries out the executive leadership role of trade policy formulation, as well as representing the country in foreign trade matters. This leadership role involves negotiating trade agreements. Previously, these executive responsibilities sat with the Ministry of Foreign Affairs. To confuse matters slightly, the Ministry of Foreign Affairs is still tasked with negotiating and signing up to bilateral investment treaties. Coordination between the two ministerial entities occurs under inter-ministerial councils, such as the Committee for International Trade (COMEX) and the Strategic Committee for the Promotion and Attraction of Investments (CEPAI), as described below. The former Institute for Export and Investment Promotion (ProEcuador) is currently the Vice-Ministry of Export and Investment Promotion. Formerly a decentralized agency, ProEcuador had much more independence and a larger budget. Now, as part of the newly formed Vice-Ministry, it has ceded responsibility for the promotion exports and investments to two separate Sub-Secretariats: the Sub-secretariat for Export Promotion and the Sub-secretariat for Investment Promotion.

The Sub-Secretariat for Export Promotion operates with less autonomy and with more budgetary restrictions than in the past. Consequently, its export promotion activities are being redefined, as are the services previously provided to exporters. In addition, it appears that some of the studies and diagnostics on export potential and competitiveness that it formerly carried out are now falling under the scope of work of other vice-ministries. Lack of communication and coordination amongst these new agencies represents a major challenge.

The Sub-Secretariat for Investment Promotion plays a role in policy making, regulation, and investment promotion. Its work has so far concentrated primarily on approving and administering investment contracts. Tax incentives granted to investors under such contracts have been recently enhanced by the new Organic Law for Productive Promotion, Investment Attraction, Employment Generation, and Fiscal Stability and Balance, approved in late 2018. The role of investment promotion, namely, attracting FDI and providing support services to foreign investors, seems weak. This is as true for the new umbrella ministry as it is for the Sub-Secretariat for Investment Promotion (despite the latter having precisely this mandate).
The goal of this institutional reform, which was carried out in the context of limited fiscal resources, was to increase the efficiency and coordination of the public sector’s promotion of private-sector development and international trade. The organization of the new Ministry of Production, Trade, Investment, and Fisheries broadly follows international practices, and there are a few areas in which the new institutional model can be improved to ensure that priority investment and export promotion and maintenance functions are carried out effective.

Three features of the new institutional model could be strengthened to ensure that the intended goals of the reform are fully achieved. First, responses to requests by exporters and investors could be made more swiftly. Slow responses times began occurring after the consolidation of the trade and investment promotion agency into the new ministry. International practices indicate that promotion agencies are technical and specialized bodies that focus more on policy implementation than bureaucracy, which is more proper to a ministry. The absorption of the agency should therefore be reassessed. Second, investment promotion functions need to be revamped. Contrary to what its name suggests, the Sub-Secretariat for Investment Promotion currently focuses more on investment policy and regulation than on actual investment promotion. A clear, proactive strategy for promoting investment is required. If FDI into Ecuador is to become more diversified, then it is important that this strategy targets a variety of sectors (i.e. not just mining). Third, the new ministry should be the lead technical entity responsible for defining Ecuador’s international trade and investment policies, including bilateral agreements. At present, Decree No. 252 gives this responsibility to the Ministry of Foreign Affairs. To improve institutional coordination in international negotiations, it is important to clarify this apparent inconsistency.

A Modern Trade Policy Standpoint

Ecuador's trade policy during the last decade was characterized by a protectionist stance locally and a passive standpoint internationally. At the same time, peer nations have been strengthening relations with one another and with higher-income nations. Consequently, Ecuador’s level of connection with international markets falls well below that of other countries in the region. This hampered the international competitiveness of domestic enterprises.

Negative consequences for productivity growth can result from tariff schedules that place high import duties on final goods (to protect them from import competition) and low tariffs on inputs (to promote their local transformation) in the attempt to protect local industries. This policy, known as tariff escalation have adverse consequences in environments where output markets have limited competition from external and/or internal forces. This is due to the increased markups and lower innovation that can result. While the objective of the policy is to support domestic producers, such producers could end up facing tariffs on imported inputs that cause production costs to rise. In an environment with limited domestic competition, such a trade policy could incentivize inputs to flow from more productive industries to less productive industries. This would result in a lower level of aggregate productivity. Measuring the

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27 Tariff escalation can also have negative welfare effects because higher prices derived from a non-competitive environment result in lowering consumption and the pricing out of some consumers from the market (Aghion et al. 2005). Incentives for import-substituting industries and distortions in input markets could also result in a misallocation of resources in the economy, detrimentally affecting aggregate productivity (Eslava et al. 2004).
impact of the structure of Ecuador’s trade policy on various outcomes is therefore key to assessing future drivers of growth.

The computation of effective rates of protection reflects Ecuador’s 2007 tariff escalation regime, which was established with the goal of incentivizing domestic value addition, protecting jobs, and substituting imports of final products for domestic production. Reductions in the most-favored nations (MFN) nominal tariff rates were mostly focused on primary products, inputs, and capital goods, whereas increases concentrated on durable and non-durable consumer goods. The effective rates of protection (including MFN rates with compound tariffs and other duties) for around 150 tradable sectors were computed, employing the 2012 input-output matrix. The results indicate that the effective rate of protection is on average larger than the nominal rate, indicating a policy to liberalize inputs and protect final products (tariff escalation).

The ample array of compound tariffs (a combination of ad valorem tariffs and volume or quantity-specific duties) negatively affected Ecuador’s value added and total factor productivity (TFP) growth. Employing an econometric model, we estimate the impact of the nominal and effective protection structure with and without compound tariffs and other duties on value added and total factor productivity growth for the period 2007-2017. Results indicate that compound tariffs and other duties had a significant, negative impact on sectoral productivity and value added. In other words, the sectors that are protected by these cumbersome tariffs show relatively lower productivity and value added than other sectors.

These negative impacts seem to be driven by widening productivity gaps within sectors, with less efficient firms being prevented from exiting the market. The correlation between the top and bottom tenth percentile of TFP within sectors with the protection variables were estimated, employing the same empirical method outlined above. Results suggest that protection rates that account for the compound tariffs and other duties increase resource misallocation. Likewise, this protection structure reduces market concentration by allowing less efficient firms to remain in the market.

Ecuadorian economy also faced costs associate with its limited engagement in trade and investment agreement such the Pacific Alliance Agreement. The signing of agreements among countries that exclude Ecuador increased the relative cost of doing business in Ecuador for firms in member countries, with

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28 The effective rate of protection accounts for the protection of the output market net of the its inputs’ protection. Specifically, the effective rate of protection is defined as $ERP = \frac{t - \sum ai ti}{1 - \sum ai}$, where $t$ is the nominal tariff, $ai$ is the proportion of imported input cost in the total cost of producing the commodity, and $ti$ is the tariff rate imposed on the imported input.

29 For instance, agriculture, livestock, forestry, and fishing face a median effective protection rate that is substantially higher than the nominal rate. However, significant heterogeneity persists within industries. For example, basic manufacturing shows higher median and average nominal and effective rates compared to those from more sophisticated manufacturing sectors.

30 We use a fixed-effect mode to relate changes in tariffs to industry-level productivity and value-added outcomes. Industry-level performance measures were computed using the financial statements for each formal firm included in the business registry database (Superintendencia de Compañías) between 2007 and 2017. Industry outcomes are aggregated at the industry level, weighting the firm by its importance in the sector.
possible negative impacts on Ecuadorian exporters and importers. Set up in 2011 by Chile, Colombia, Mexico, and Peru, the Pacific Alliance is a trade bloc that provides its four-member states with freedom of movement for goods, services, capital, and people. The Pacific Alliance members represent an important destination for Ecuadorian exports and an important origin for Ecuadorian imports. They account for almost 20 percent of Ecuador’s non-oil exports and over 25 percent of its non-oil imports. Estimates suggest that the decision to remain outside the Pacific Alliance Agreement decreased Ecuador’s overall exports by an estimated 16 percent. This corresponds to a loss of US$600 million per year.

The overall results suggest that reverting Ecuador’s approach to import tariffs and trade integration is critical to foster productivity growth and reducing costs of doing business. A rationalization of the compound tariffs and other import duties applied in Ecuador could have a positive impact on productivity growth through a reallocation of factors toward more productive industries. The current protection structure is leading to significant resource misallocation, with capital and labor remaining in sectors with limited growth potential instead of flowing into more productive sectors. In addition, compound tariffs increase uncertainty for importers. This is because final import costs depend on the volume or quantity-specific duties (weight for example) that can easily be subject to measurement errors (e.g. differences in calibration on weight at ports versus exporter warehouses) or to informal rents by government officials.

The timing and composition of reform agenda should be managed carefully. The internationalization and integration of Ecuador’s economy can bring a range of benefits presented in the section, but the full materialization of benefits depend on the implementation of a broader and complementary reform agenda to address fiscal imbalances and price and allocative distortions in Ecuador’s economy. A quick and isolated move towards opening the economy could amplify external imbalances in the short-run. In contrast, implementing a broad reform agenda strategically would create the bases for transitioning to the balanced, productivity-driven, and sustainable economic model Ecuador aspires.
Final Considerations

**Ecuador has embarked on a new policy course.** The country faces the challenge of consolidating the social gains of recent decade while addressing the excesses of the boom period and bringing the economy to a sustainable path. This policy note presented the nature of the imbalances faced by Ecuador’s economy and identifies key areas for reform that will contribute to reestablishing macroeconomic stability and increase the competitiveness of the Ecuadorian economy, while safeguarding recent social gains. It systematically presents policy options to be consider within each area. The note draws upon the findings of a body of analytical work produced by the World Bank during the last two years. After reviewing the economic context for Ecuador, the note focus on efforts to achieve three main objectives:

I. **Fiscal consolidation and public sector efficiency**: to downsize public sector demand and return to fiscal and external sustainability

II. **Restoring competitiveness**: by increasing flexibility of prices and mobility of factor toward more productive activities.

III. **Invigorating an outward looking private sector**: by creating conditions for the private sector to take a more prominent role as the state adjusts and seize the opportunities created by the newly regained competitiveness.

Key policy options to achieve these objectives are summarize below:

### I. Fiscal consolidation and efficiency of the public sector

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fiscal Framework, PIM, and PFM</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduce a fiscal framework (fiscal rule, sovereign fund) that pragmatically reflects the political commitment and capacity in the country</td>
<td>MT</td>
<td>UI</td>
</tr>
<tr>
<td>Establish a fiscal strategy and medium-term fiscal framework (MTFF)</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Strengthen budget preparation with systematic top down budget controls Reduce the room for discretionary changes during budget execution</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Aligning fiscal accounting and reporting with international standards</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Develop a sound regulatory and institutional framework for PPP align with international good practices</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Create an integrated PIM system, including central and subnational government, with strong planning (of PI and PPPs) and prioritization capacity.</td>
<td>ST to MT</td>
<td>UC*</td>
</tr>
</tbody>
</table>

*Increasing Tax Revenues and Efficiency – yield up to 2 percent of GDP in revenues*

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31 ST- shot-term, MT medium-term
32 I – implemented, UI – under implementation, UC – under consideration, NI – not initiated. * - supported by Inclusive and Sustainable Growth DPL series.
| **Increase VAT (2 to 3p.p.) to align with regional standards** | ST | UC* |
| **Revise VAT exemptions to improve target** | ST to MT | UC* |
| **Revise the PIT schedule** | ST | UC* |
| **Further cap PIT deductions** | ST | UC* |
| **Apply PIT schedule to 13th and 14th wages** | MT | NI |
| **Rationalize CIT exemptions** | ST to MT | NI |
| **Simplify the mechanism for calculating minimum IT advances** | ST | UC* |
| **Allow for accelerated depreciation in the CIT calculations** | ST | NI |
| **Gradually phase out ISD and import tariffs** | MT | UI |

**Rationalizing Public Wages and Employment – yield up to 1 percent of GDP in savings**

| **Revise the salary scale for new employees** | ST to MT | UC |
| **Encourage early retirement and voluntary dismissals** | ST | UC |
| **Establish a strategic national workforce planning policy** | ST | NI |
| **Reduce the number of temporary positions in a strategically planned manner** | ST to MT | I |
| **Revise pay for incentive and performance assessment criteria c** | ST to MT | NI |
| **Revamp the human resource management systems** | ST to MT | UC |

**Promoting Strategic Public Procurement - yield up to 1.5 percent of GDP in savings**

| **Consolidate contracts to purchase goods of high volume and low complexity** | ST | UI* |
| **Expand the use of e-catalogues, deploy reverse auctions more selectively** | ST | UI* |
| **Curb noncompetitive procurement, especially for “menor cuantia” and “regimen especial”** | ST | UC |
| **Improve electronic processes to support award processing** | ST to MT | NI |
| **Improve procurement planning and the predictability of budget release to avoid concentration of purchases in the last months of the year** | ST | UC* |
| **Modernize procedures and information for contract management** | ST | NI |
| **Allow more time for bidders to prepared responsive bids** | ST | UC |
| **Publish an electronic request for bid, and notify electrically registered bidders of any bidding opportunity on their areas of business** | ST | UC |

**Increasing Efficiency of Spending in Basic Education – fiscally neutral**

| **Rebalance current spending between higher and basic education** | ST to MT | UC |
| **Rebalance public investment between higher and basic education** | ST | UC |
| **Focus those resources on strengthening the quality of basic education** | ST to MT | UC |

II. Restoring competitiveness
### Flexible and efficient labor markets

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplify minimum wage structure, eliminating sectorial minimum wage by occupation and focusing on one universal minimum wage</td>
<td>ST</td>
<td>NI*</td>
</tr>
<tr>
<td>Create a metric (formula), link to inflation and productivity gains, to guide minimum wage increases.</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Reinstate term and part time contracts</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Reinstate hourly contracts</td>
<td>MT&lt;sup&gt;35&lt;/sup&gt;</td>
<td>NI</td>
</tr>
<tr>
<td>Rationalize dismissal costs by imposing a cap on severance payments, and reducing or eliminating payments for voluntary resignation</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Reduce the minimum mandatory profit-sharing rate (currently and 15%) and rationalize its application (e.g. exclude firms in the first years of operation)</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Reform the unemployment ensures to ensure it is an effective safety-net under more flexible labor regulations—speed up access, simplify processes, expand the benefit to independent workers</td>
<td>ST to MT</td>
<td>UC</td>
</tr>
</tbody>
</table>

### Improving Financial Markets

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gradually eliminate of interest rate ceilings.</td>
<td>ST to MT</td>
<td>UC*</td>
</tr>
<tr>
<td>Integrate the domestic and international demands in the auctions of government instruments</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Reform mechanisms of financing of public banks, including the elimination of mandatory funding by commercial banks (liquidity requirement), and direct financing from the deposit insurance fund.</td>
<td>ST</td>
<td>UC</td>
</tr>
<tr>
<td>Reform the governance of public banks, by limiting risks of political influence and defining objectives and target markets</td>
<td>MT</td>
<td>UC*</td>
</tr>
<tr>
<td>Level the playing field in the regulation and supervision of public and commercial banks.</td>
<td>ST</td>
<td>UC*</td>
</tr>
<tr>
<td>Improve the regulatory framework of the cooperative sector, including capitalization and further consolidation.</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Adopt Basel III regulation.</td>
<td>MT</td>
<td>NI</td>
</tr>
</tbody>
</table>

### Agricultural support policies

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abolish MPS and substitute them to other support models</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Gradually phase out import tariffs and quotas on agriculture products</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Provide targeted subsidies or guarantees to land development loans</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Provide targeted subsidies or grants to irrigation investments</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Facilitate access to fertilizers</td>
<td>ST</td>
<td>NI</td>
</tr>
</tbody>
</table>

<sup>33</sup> ST- shot-term, MT medium-term  
<sup>34</sup> I – implemented, UI – under implementation, UC – under consideration, NI – not initiated. * - supported by Inclusive and Sustainable Growth DPL series.  
<sup>35</sup> Require constitutional changes and intense consensus building among stakeholders.
Develop disaster monitoring systems and forecast weather information programs  
Develop insurance mechanisms against weather shocks  
Facilitate training and relocation of agriculture workforce

III. **Invigorating private sector investment, trade, and employment generation:**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing</th>
<th>Status</th>
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</thead>
<tbody>
<tr>
<td><strong>Institutional framework for trade and for investment policy and promotion</strong></td>
<td></td>
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<tr>
<td>Promote collaboration and coordination between the vice-ministries of the umbrella ministry</td>
<td>ST</td>
<td>UC</td>
</tr>
<tr>
<td>Transfer the responsibility of negotiating and subscribing international investment agreements Ministry of Production, Foreign Trade, Investment and Fisheries</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Focus CEPAI mandate on defining Ecuador’s investment strategy and policy direction on investment matters</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Focus COMEX mandate on defining the overall direction of Ecuador’s foreign trade policies and coordination of actors</td>
<td>ST</td>
<td>NI</td>
</tr>
<tr>
<td>Align export and investment promotion agencies with international best practices by making them technical and specialized executing entities, with considerable autonomy and budgetary independence from lead ministries.</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
<tr>
<td>Strengthen ProEcuador’s investment promotion mandate to provide professional support services to investors throughout the investment life cycle.</td>
<td>ST to MT</td>
<td>UC</td>
</tr>
<tr>
<td><strong>Modern trade policy standpoint</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advance negotiations to join the Pacific Alliance</td>
<td>ST</td>
<td>UI</td>
</tr>
<tr>
<td>Step-up the efforts to negotiate trade and investment agreements</td>
<td>ST to MT</td>
<td>UC</td>
</tr>
<tr>
<td>Gradually rationalized and phase out compound tariffs and other import duties</td>
<td>ST to MT</td>
<td>NI</td>
</tr>
</tbody>
</table>

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36 ST- shot-term, MT medium-term  
37 I – implemented, UI – under implementation, UC – under consideration, NI – not initiated. * - supported by Inclusive and Sustainable Growth DPL series.  
38 It is important to proceed with these reforms gradually and carefully coordinated them with other fiscal and structural reforms to increase competitiveness. An abrupt and premature broad-based tariff cut could amplify external imbalances in the short run.
### Primary References

<table>
<thead>
<tr>
<th>Code</th>
<th>Title and Details</th>
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<tbody>
<tr>
<td><strong>SCD</strong></td>
<td>Systematic Country Diagnostic – June 2018</td>
</tr>
<tr>
<td><strong>DPL</strong></td>
<td>INCLUSIVE AND SUSTAINABLE GROWTH DPF - PROGRAM DOCUMENT – April 9, 2019</td>
</tr>
<tr>
<td><strong>IMF</strong></td>
<td>IMF - Staff Report for the 2019 Article IV Consultation and Request for an Extended Arrangement Under the Extended Fund Facility – March 2019</td>
</tr>
<tr>
<td><strong>PFR</strong></td>
<td>PFR – Revised tax chapter – May 2019</td>
</tr>
<tr>
<td><strong>TIC</strong></td>
<td>Trade and Investment Competitiveness, May 2019</td>
</tr>
<tr>
<td><strong>fin</strong></td>
<td>Ecuador Financial Sector – May, 2019</td>
</tr>
<tr>
<td><strong>PIM</strong></td>
<td>Public Investment Management – May, 2019</td>
</tr>
</tbody>
</table>