Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 13-May-2019 | Report No: PIDA26827

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Ecuador	P169822	First Inclusive and Sustainable Growth DPF (P169822)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
LATIN AMERICA AND CARIBBEAN	11-Jun-2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Republic of Ecuador	Ministry of Economy and Finance		

Proposed Development Objective(s)

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

Financing (in US$, Millions)

SUMMARY

Total Financing	500.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. **Ecuador achieved high growth and significant social gains during the last oil price boom, but it accumulated macroeconomic vulnerabilities.** GDP growth averaged 4.5 percent between 2001 and 2014, well above the regional average of 3.3 percent. During this period, real GDP per capita increased by 43 percent. Poverty fell from 37 to 22 percent of the population between 2007 and 2017, lifting 1.4 million people out of poverty. Social gains were supported by higher labor incomes, redistribution, and better access to services. These results were accompanied by a large expansion of the public sector which became the main driver of growth after 2007. Public spending increased exceptionally from 20 percent of GDP in 2004 to 44 percent by 2014, largely driven by an expansion in public investment. Public sector expansion strengthened service delivery, but at the expense of efficiency.[1] The expansion was partially financed by higher oil revenues.[2] However, over this period, Ecuador also dismantled its sovereign oil funds, incurred a selective debt default, increased its public debt from 17 percent of GDP in 2012 to 27 percent in 2014. This expansionary fiscal instance accentuated the symptoms of Dutch disease, which combined with a non-conducive business environment dampened private investment.

2. **The country is now facing the difficult process of adapting its economy to volatile oil prices and tightened external financing.** With a dollarized economy and limited fiscal buffers, Ecuador could neither depreciate its currency nor undertake countercyclical fiscal policies when oil prices dropped in 2014. As revenues plummeted, the government cut spending, mainly public investment, accentuating an economic deceleration in 2015-16. Despite these efforts, fiscal deficits widened, arrears accumulated, and the public debt increased swiftly, reaching 46 percent of GDP in 2018. External imbalances and led to a sharp decline in international reserves since 2015, with temporary reliefs when Ecuador manage to mobilize costly external financing. Poverty reduction lost momentum during this time. Poverty increased one percentage point (from 22 to 23 percent) between 2014 and 2018. The labor market conditions deteriorate, while fiscal pressures led to a reduction in coverage of the country's main CCT program. Adapting to this challenging external context will require addressing macro-fiscal imbalances and shifting from a State-led economic model to a balanced, productivity-driven economy. However, the adjustment process must be carefully managed to safeguard the social achievements of the last two decades.

Relationship to CPF

3. **The World Bank Group is developing a new Ecuador Country Partnership Framework (CPF) FY19-FY23, which aims at rebalancing the economy, reigniting sustainable growth and protecting the vulnerable.** This is the first World Bank Strategy for Ecuador since 2007. The new-CPF is being prepared in parallel to this operation. It focuses on achieving the twin goals of the World Bank Group—ending extreme poverty and boosting shared prosperity—through three interdependent areas where expected results are aligned with the Government's priorities outlined in *Plan de Prosperidad* and the key challenges identified by the 2018 Ecuador SCD. Those are: i) supporting fundamentals for inclusive growth, ii) building human capital and protecting the poor, iii) enhancing Institutional and environmental Sustainability. Pillars 1 and 2 of the proposed DPL series support CPF objectives under results area i), while pillar 3 supports CPF objectives under results area ii).

[1] Ecuador SCD 2018.
[2] In 2011, the government renegotiated oil contracts with the private sector, resulting in a larger share of oil revenues flowing to the public sector

C. Proposed Development Objective(s)

4. **This DPF series support reforms to: i) promote a more efficient mobilization and allocation of government resources; ii) reduce barriers for private sector development; iii) protect and include vulnerable segments of the population.** The series supports the government's efforts to adapt to the challenging external environment and transition to a sustainable and inclusive growth model. Reforms under pillar 1 promote a more efficient mobilization and allocation of government resources, helping reduce fiscal imbalances. They support improvements in budget processes, rationalization of current spending, and improvements tax collection. Reforms under pillar 2 reduce barriers to private sector development, supporting a more balanced growth process. They include regulations enabling private investments in the oil sector, fostering PPPs, lowering costs to opening first, and reducing financial sector distortions. Finally, reforms under pillar 3 protect and include vulnerable segments of the population. They include efforts to improve the effectiveness of social protection programs, design target compensations against policy reforms, and promote financial inclusion.

Key Results

The expected results of the series are improving the budget preparation process and aligning it with fiscal sustainability objectives; increasing efficiency in the purchase of goods and services and personnel; modernizing fuel and electricity pricing to rationalize subsidies and increase efficiency; increasing non-oil government revenues and reduce distortions in the tax system; removing regulatory barriers to foreign investment by reintroducing dispute settlement mechanisms and enhancing the institutional framework for PPPs; removing barriers to firm entry and operations, by establishing a new Simplified Stock Corporation modality, reintroducing the principle of limited liability and reducing non-tariff barriers for imports; reducing inefficiencies in the financial sector by reducing minimum liquidity requirements, improving the governance of public banks, and taking steps towards removing interest rate ceilings; improving the targeting of social programs by expanding the objectives and defining the governance of the social registry; increasing access to formal jobs, especially for women and youth; and promoting financial inclusion by increasing the transparency and regulation of the cooperative sector and expanding its reach.

D. Project Description

5. **Pillar 1 support reforms that promote a more efficient mobilization and allocation of government resources, supporting an orderly fiscal consolidation.** Weakness in budgetary process and current spending rigidities have prevented a strategic fiscal adjustment and the government has relied most capital spending cuts to address fiscal imbalances in recent year. Relatively low non-oil revenues added to fiscal pressures. Reforms proposed under pillar 1 seek to address these challenges. They help strengthen MEF's capacity and oversight during budget preparation and execution, aligning budgetary processes with fiscal sustainability objectives, in line with international best practices. Reforms also help improve procurement and HR processes, allowing for savings on goods and services and personnel spending. Additionally, Reforms support changes on the pricing of energy products aligning incentive and reducing Ecuador's large and poorly-target subsidies. Finally, reforms under pillar 1 support a more efficient revenue mobilization by improving tax policy.

6. **Pillar 2 support reforms focused on removing barriers for private sector development.** These barriers range from regulatory uncertainty, high costs to open and close businesses, and distortions in financial markets that limit access. Previous administrations enacted a series of legal changes that stymied private investment. For example, the government of Ecuador changed the structure of oil contracts to retain a higher share of oil revenue at the same time as it withdrew from ICSID. These changes discouraged foreign direct investment. Regulatory changes have also affected importing and

exporting firms. Reforms are needed to bolster a more amenable environment for firm entry and operation. Despite recent progress, regulations make it difficult to open and close a firm. The time and costs involved in registering a new business in Ecuador are high compared to regional peers. Access to finance is also considered by business to represent an important obstacle, especially for larger firms. Regulatory barriers limit financial sector performance. For example, interest rate ceilings exclude borrowers priced out of formal credit markets under current caps. Reforms under pillar 2 aim to reduce barriers to private sector development, supporting a more balanced growth process. They include regulations fostering large investment, including public-private partnerships (PPPs), lowering costs for opening firms and importing, reducing financial sector distortions and improving complementarity between public and private financing institutions.

7. **Pillar 3 support reforms that seek to protect vulnerable segments of the population against the impacts of ongoing fiscal consolidation efforts and include these segments in the process of economic development.** Ecuador witnessed substantial economic and social gains between 2001 and 2014. High economic growth coupled with an improved income distribution helped lift 1.4 million people out of poverty. Macroeconomic vulnerabilities came to the fore in 2014, affecting the Government capacity to protect the poor. Fiscal pressures lead to a decline in public transfers. The reductions were based on outdate information system. It increased exclusion errors, while still including an important share of no-poor in the system. The adjustment reduced the impact of redistribution on poverty reduction between 2014 and 2017. The Government of Ecuador is committed to implement reforms that can ensure that existing fiscal space is allocated towards effective protecting the poor and the vulnerable and that these groups have opportunity to engage in the process of economic development.[3] With limited fiscal space, the impacts of consolidation reforms need to be mitigated by establishing a well-targeted, efficient, and sustainable safety net to protect the achieved social gains. Reforms under pillar 3 aim to protect and include vulnerable segments of the population. They include efforts to improve the effectiveness of social programs, design targeted compensations against the impacts of policy reforms, promote formality by tailoring labor markets to the needs of vulnerable segments of the population, and promote financial inclusion.

E. Implementation

Institutional and Implementation Arrangements

8. **Ministry of the Economy and Finance (MEF) will be the main coordinating agency for monitoring and evaluation among other participating ministries.** The prior actions detailed in this operation are the prime responsibility of the following ministries and agencies: MEF, Ministry of Energy, Ministry of Production, Investment, and Commerce, National Planning Agency (SENPLADES) Energy, Hydrocarbon Regulatory Agency (ARCH), and Electricity Regulatory Agency (ARCONEL). ANSES, and the Office of the Presidency of Cabinet of Ministers. MEF would be the coordinator with other ministries on monitoring of the results indicators, which are based on publicly available information. The World Bank will be monitoring the implementation of the DPF program through regular supervision missions and the preparation of the DPF 2. The World Bank will also collaborate with the Ministry of the Treasury on the monitoring the key indicators for the DPF.

The program outcomes will be monitored through the measurement of the progress toward the achievement of results indicators included in the policy and results matrix. This measurement seeks to assess progress toward the implementation of the policy and institutional measures supported by the proposed DPF series and will be evaluated

[4] This PSIA was produced by Sergio Olivieri (GPVDR), Leandro Chalela (GPVDR), Ana Rivadeneira (GSURR) and Ivan Gachet (GMTTT).

following the disbursement of the first DPF. MEF will have the responsibility of presenting the information related to the reform implementation and progress made toward results on time and in a format satisfactory to the World Bank.

F. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

9. **The prior actions supported by this operation are expected to have neutral or positive effects on poverty reduction in the short term and overall positive effects over the medium and longer term.** This assessment[4] follows the Bank guidelines and provides an analysis of the potential distributional effects of the government's program. It covers poverty and shared prosperity implications, as well as other welfare related outcomes such as household income and expenditures, employment, and prices. The policies supported by this operation such as the measures for increasing the efficiency in the mobilization and allocation of public resources, are expected to strengthen the fiscal position of the government. In addition, the prior actions aimed at removing barriers for private sector development are expected to facilitate private sector investment and develop and strengthen financial markets in Ecuador. Although not all these policies and programs would have direct effects on poverty and inequality, their overall impact on welfare is estimated to be neutral or positive. Finally, the policies for protecting and including vulnerable populations are not expected to have significant impacts on the welfare of the less well-off in the short-run. However, these measures establish the bases for a proper functioning of a social protection system, economic opportunities for women and financial inclusion of the bottom of the distribution. The expected effects are based on quantitative analysis, the review of academic literature, and additional information gathered during the preparation of the operation.

Environmental Aspects

10. **The policies supported by the proposed DPF are not likely to have negative impacts on the country's environment or its natural resource base. Two PAs are expected to result in overall positive effects on Ecuador's environment and natural resource base:** PA3, which eliminates subsidies for premium gasoline, is expected to lead to lower consumption of those fuels by incentivizing more efficient use. The Government raised the prices at the pump for all types of gasoline, such that any substitution effects should be minimal. Currently, the great majority of private cars being used and produced run on gasoline and there is inertia of the automotive capital stock. The elimination of the subsidy for diesel used for industrial purposes is not expected to lead to adverse impacts given that it was accompanied by price liberalization of other fuels, including heavy fuel oils. PA4 is expected to reduce distortions in electricity pricing, providing incentives for reducing consumption through three mechanisms: i) Removing leakages in the social tariff to prevent double dipping from those already benefiting from pricing in the bottom block of electricity tariffs; ii) eliminating subsidies for off-peak industrial electricity tariffs, and iii) the introduction of enforce effective pricing discipline by reducing non-payment and arrears. The combined effect of measures i) and iii) is predicted to be a decrease in greenhouse gas emissions, contributing to Ecuador's climate change agenda, and potentially decreases in air pollution where oil-fired thermal electric plants are operating, with related benefits for air quality.

[4] This PSIA was produced by Sergio Olivieri (GPVDR), Leandro Chalela (GPVDR), Ana Rivadeneira (GSURR) and Ivan Gachet (GMTTT).

G. Risks and Mitigation

11. **The overall risk rating of this operation is assessed as high**. The major risks to the operation's ability to achieve its development objective include macroeconomic risks and institutional capacity for implementation and sustainability risks. In addition, challenges related political and governance, fiduciary, and stakeholder risks are considered substantial. Risks associate with sector strategies and policies, technical design of the program, environment and social impacts are considered moderate. The high risks for this operation are anchored in the macroeconomic and political risks. If macroeconomic risks were to materialize, they would adversely affect the Government's ability to implement and sustain the reform efforts – especially if they trigger social discontent – and hence make the outcome of the development agenda less successful. The political dynamics could also affect the Government's ability to mobilize parliamentary support to approve some of the reforms included in the program. Close supervision and engagement through the IMF, World Bank, IDB and CAF-supported programs will help mitigate macroeconomic risks, while intense coordinated technical assistance by these institutions will help mitigate risks associated with low capacity for implementation. The Government has also intensified consultations and is developing carefully assessed communication strategies to explain the reforms to the assembly and broad public, which is expected to help mitigate political risks. Finally, the DPF program is designed to include flexibility for the second operation to adjust in case some of these risks materialize.

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APPROVAL

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