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Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 28-Jun-2024 | Report No: PIDDA00112

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Operation ID	Operation Name	
Ecuador	P505747	Ecuador Carbon-Conscious Fiscal and Growth Development Policy Financing	
Region	**Estimated Approval Date**	**Practice Area (Lead)**	**Financing Instrument**
LATIN AMERICA AND CARIBBEAN	31-Jul-2024	Macroeconomics, Trade and Investment	Development Policy Financing (DPF)
Borrower(s)	**Implementing Agency**		
Republic of Ecuador	Ministry of Economy and Finance		

Proposed Development Objective(s)

The Program's Development Objective (PDO) is to support reforms by the Government of Ecuador (GoE) to enhance fiscal sustainability and to enable private investment and female labor force participation.

Financing (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Financing	**500.00**

DETAILS

Total World Bank Group Financing	**500.00**
World Bank Lending	500.00

Decision

The review did authorize the preparation to continue

Explanation

B. Introduction and Context

Country Context

The proposed Ecuador Carbon-Conscious Fiscal and Growth Development Policy Financing (DPF) supports key reforms to enhance fiscal sustainability and enable private investment and female labor force participation. Fiscal reforms supported by this operation are projected to reduce Ecuador's financing needs by a cumulative 2 percent of gross domestic product (GDP) in 2024 and 2025, which is critical to safeguard fiscal sustainability and address bottlenecks to growth.[1] To mitigate a potential impact on vulnerable households, additional financing is provided for the WB Social Safety Net Project which will extend cash transfers to about 100,000 families by the end of 2025. In addition to the country's structural deficit, growth studies on Ecuador generally identify the country's barriers to private sector investment, and low female labor force participation as main impediments to growth[2]—areas that this program addresses. The DPF also supports reforms that are critical for Ecuador's energy transition by raising the total price of carbon and opening the electricity sector to investments in renewable energy. Finally, these reforms will help the diversification of energy sources and increase climate resilience of the sector under increasing droughts.

The proposed stand-alone DPF loan of $500 million benefitted from a swift engagement with the new administration that took office in November 2023 and sustained analytical and technical assistance and lending engagements by the World Bank Group (WBG) in support of fiscal and structural growth reforms in Ecuador.[3] This DPF is part of a package of coordinated financial assistance from international partners, including the International Monetary Fund (IMF), the Inter-American Development Bank (IDB), and the Development Bank of Latin America and the Caribbean (CAF). The proposed operation is aligned with the Green, Resilient, and Inclusive Development (GRID)[4] framework, and the World Bank Group's Roadmap for Climate Action in Latin America and the Caribbean.[5] It also supports the operationalization of the Ecuador Country Climate and Development report (forthcoming) by supporting the fuel subsidy reform, Ecuador's adaption to climate shocks and the energy transition.

Ecuador's government is grappling with a challenging trilemma: an unprecedented security crisis, fragile public finances, and sluggish economic growth. Ecuador's homicide rate more than doubled in 2023, becoming one of the highest in the region, leading to the declaration of a state of internal armed conflict in January 2024. Climate events and historically low investment in the electricity sector led to widespread electricity rationing in the last quarter of 2023. Amid these challenges, snap elections led to a fragmented National Assembly and an interim government with an 18-month mandate. When this government assumed office in November 2023, it faced a challenging fiscal situation caused by budget rigidities,

[1] The DPF is fully aligned with the National Development Plan 2024–2025 (*Plan de Desarrollo para el Nuevo Ecuador 2024-2025*, NDP), *Plan Económico 2024/25*, and the Country Partnership Framework (CPF) FY2019–FY2023, extended by the Performance and Learning Review (PLR) to FY2025.
[2] World Bank. 2024. Country Economic Memorandum, *Ecuador: Growing Resilient for a Better Future*; World Bank. 2016. *Ecuador: Country Economic Memorandum: Productivity Growth under Adverse Global Conditions.* Unpublished report.
[3] World Bank. 2024. Country Economic Memorandum, *Ecuador: Growing Resilient for a Better Future*.
[4] World Bank. 2021. From COVID-19 Crisis Response to Resilient Recovery – Saving Lives and Livelihoods while Supporting Green, Resilient and Inclusive Development (GRID).
[5] World Bank Group. 2021. Climate Change Action Plan 2021–2025: Supporting Green, Resilient and Inclusive Development.

spending pressures due to the El Niño weather phenomenon and the security crisis, declining oil prices and production, legislative demands in a context of political instability, and a slowing economy. Economic growth has been tepid at 2 percent over the last decade, which compounds the difficulty of addressing a sustained structural central government's fiscal deficit in a context where many social demands remain unmet. Adding to the fiscal and growth challenges, a referendum in August 2023 mandated the cessation of oil extraction in the Yasuni National Park by the end of August 2024, affecting one-tenth of the national oil production, a key source of fiscal revenues and access to foreign reserves. President Noboa acted decisively following a series of violent, highly visible gang-related attacks, which bolstered his popular support and enabled him to push for stringent anticrime measures through a referendum. However, voters rejected other reforms that could have spurred growth, such as the legalization of hourly contracts and the international arbitration of commercial disputes.

The Noboa administration has taken important steps to tackle a challenging fiscal situation, including by implementing reforms—supported by this Development Policy Loan (DPL)—on domestic resource mobilization and spending efficiency. Non-oil revenues as a share of GDP are low compared to other countries due to low value added tax (VAT) rates and high tax expenditures (World Bank 2019). The government, therefore, rapidly enacted important revenue reforms, such as raising the VAT rate permanently from 12 to 13 percent (Priority Action #1,PA#1) and temporarily to an additional two percent. Additionally, with World Bank (WB) technical assistance, the government rationalized gasoline subsidies (PA#2), saving at least 0.3 percent of GDP; passed a wage bill reform (PA#4), saving about 0.2 percent of GDP; and curbed tax incentives (PA#5), saving about 0.2 percent of GDP. The government is also improving spending efficiency by limiting exceptions to competitive procurement, adopting private sector managerial practices in major state-owned enterprises (SOEs) like PetroEcuador, and improving customs revenue collection. Together, these reforms are expected to yield fiscal savings of a cumulative about 2 percent of GDP in 2024 and 2025, while reducing the fiscal risks related to economic fluctuations and commodity price shocks. These fiscal reforms are critical for addressing the structurally high central government's fiscal deficit, a necessary condition for Ecuador's return to international capital markets at reasonable costs.[6]

Enabling private capital investment is critical for boosting potential growth within a fiscally constrained environment. The competitive expansion of the private sector is essential toward reducing state dominance in markets that are important drivers of growth, increasing competitiveness, and alleviating the burden on public finances (World Bank 2024).[7] In this context, the DPL supports critical improvements in Ecuador's legal and regulatory framework, increasing regulatory certainty, and removing distortions that have caused state dominance. These efforts have been closely coordinated with the International Finance Corporation (IFC) in an effort to leverage the reforms for potential IFC transactions in support of private sector investment. In particular, the DPL supports a reform of the public-private partnership (PPP) law (PA#5), which has benefitted from one WBG technical assistance. If technically feasible, IFC would structure three PPP road project transactions and lead efforts to bring them to market, thereby attracting private investment of more than 0.2 percent of GDP. Reforms that increase the price of carbon and support increased electricity demand from renewable sources have opened the scope for IFC investments in the electrification of productive units. Following the removal of the shrimp farm diesel subsidies supported by the previous DPL program, the IFC invested in the electrification of one of the major shrimp farms. The ongoing energy crisis is directly impinging on growth. This program unlocks private investment to expand

[6] Despite a relative low debt, Ecuador has one of the highest risk rates in the region. This risk level could be explained, among other things, by political instability and a structural central government's fiscal deficit of about 5 percent of GDP. This operation is supporting measures that would allow the country to close this structural fiscal deficit by about 1.1 percent of GDP per year.

[7] The Middle-Income Trap, World Development Report, World Bank (2024, forthcoming).

generation and transmission capacities (PA#6). Additionally, it aims to diversify the power generation matrix through integrating more non-hydro renewables, given the high dependence on hydropower for electricity generation which accounted for 85 percent of electricity production in 2022. The high dependence on hydropower presents a risk to energy security given the vulnerability to droughts and recurrent El Nino events. Moreover, the recently enacted law underpins these efforts by allowing additional market participants, including joint ventures, to enter the electricity market, including two key instruments created by this same law: a short-term electricity market and a national investment fund for energy efficiency investments (PA #6).

The program also supports reforms to enhance female labor force participation and foster green jobs. In Ecuador, only 54.2 percent of working-age women participate in the labor market. Also, working women are confined to low-productivity sectors and have limited access to managerial positions. To boost quality employment opportunities for women, firms will be mandated to adopt gender-equality action plans and encouraged to seek gender-equality certifications (PA#8). Additionally, the PPP reform and the new energy competitiveness reform aim to attract private investment to the renewable energy sector, thereby generating numerous green job opportunities and contributing to the transition toward a sustainable and low-carbon economy.[8]

Relationship to CPF

1. **The DPF plays a central role in the WBG's engagement with Ecuador and is fully aligned with the WBG's FY19-FY23 CPF (Report No. 135374-EC, discussed by the Board in June 2019), and the DPF is aligned with the FY23-FY25 PLR (Report No. 175329-EC, considered by the Board in May 2023).** The CPF focuses on achieving the WBG's vision – a world free of poverty on a livable planet—through three interdependent areas: (i) Supporting Fundamentals for Inclusive Growth, (ii) Building Human Capital and Protecting the Poor, and (iii) Enhancing Institutional and Environmental Sustainability. Pillar 1 and Pillar 2 of the proposed DPF supports CPF objectives under results area (i), and (iii).

C. Proposed Development Objective(s)

The Program's Development Objective (PDO) is to support reforms by the Government of Ecuador (GoE) to enhance fiscal sustainability and to enable private investment and female labor force participation.

Key Results

[8] According to a recent International Labour Organization (ILO) and Inter-American Development Bank (IDB) study, a decarbonization-focused recovery could generate 15 million jobs in Latin America. Studies have identified that infrastructure investment paths can be compatible with full decarbonization, and they do not need to cost more than more polluting alternatives (Rozenberg. 2019. *Beyond the Gap: How Countries Can Afford the Infrastructure They Need While Protecting the Planet*). With the right policies, investments of 4.5 percent of GDP would enable low- and middle-income countries to achieve the infrastructure-related sustainable development goals and stay on track to limit climate change to 2ºC. In Chile, the Ministry of Finance led a study (the 2020 Green Growth Opportunities for the Decarbonization Goal for Chile), concluding that implementing a mitigation policy package, jointly proposed by the ministries of energy, environment, and agriculture, can have a positive impact on the economy, which could mean an additional growth of 4.4 percent of its GDP by 2050 (Hepburn, C., O'Callaghan, B., Stern, N., Stiglitz, J., and Zenghelis, D. 2020. Will COVID-19 fiscal recovery packages accelerate or retard progress on climate change? Oxford Smith School Working Paper 20-02). In addition, 2019 data from the International Renewable Energy Agency (IRENA) shows that all renewable energy technologies generated 89,236 direct and indirect jobs in Spain; 97,868 new jobs in Mexico; 17,493 in Chile; and 12,448 new positions in Ecuador.

2. The expected outcomes of this initiative include a rise in fiscal revenues and a decrease in tax expenditures. It aims to fortify the fiscal positions of subnational governments and state-owned enterprises, promote private investment in infrastructure, and increase female labor force participation.

D. Project Description

3. The DPF is fully aligned with the GoE's program. The pillars and actions reinforce the Government's priorities in the NDP and NDC:

- *Enhancing Fiscal Sustainability.* The first pillar supports critical elements of the NDP's economic and institutional pillars, which seek to strengthen fiscal revenue resilience, improve fiscal balances of SOEs and subnational governments (GADs), promote trade and investment, and reduce tax expenditures..
- *Enabling private investment and female labor force participation.* The second pillar of this operation supports the NDP's economic pillar, which, among other things, aims to enhance the PPP framework, facilitate private investment in the electricity sector, and increase women's labor force participation.

E. Implementation

Institutional and Implementation Arrangements

4. The Ministry of 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 Labor, MEM, MAATE, Internal Revenue Service, and the Office of the Presidency. MEF will coordinate with other ministries to monitor the results indicators based on publicly available information. The WB will monitor the implementation of the DPF through regular supervision missions.

5. Program outcomes will be monitored by measuring progress toward achieving results indicators included in the policy and results matrix. They will be evaluated following the disbursement of this operation. MEF will be responsible for presenting the information related to the reform implementation and progress made toward results on time upon request and in a format satisfactory to the WB.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

The supported prior actions are expected to have positive and neutral effects on distributional outcomes over the long term.

Pillar I is expected to have neutral impacts on the poor in the short run, mitigated through targeted transfers, with potential positive impacts in the long run. From a distributional perspective, household-level microsimulations indicate that increasing VAT (PA#1) is expected to have minimal negative welfare impacts on the population. While the VAT in Ecuador is slightly regressive, and the tax pressure (relative weight of the VAT in households' budgets) of households at the bottom of the income distributions already higher than those at the top, the VAT increase would result in impacts of less than 1 percent on household budgets. Similarly, the effects on the vulnerable and the middle class are small. Removing gasoline subsidies (PA#2) is estimated to have a small negative impact on equity and poverty since households in the lower part of the income distribution consume little gasoline. The indirect effect is mostly through diesel transportation, which is not affected by this reform. The impact would result in less than 1 percent in household budgets for those in the lowest deciles. To mitigate these effects, the government plans to expand social protection coverage with monetary transfer programs by at least 45,000 households, particularly for the poorest (deciles 1 and 2). Additionally, the government will provide targeted transfers to the transport sector to prevent tariff hikes and protect public transportation users. The fiscal measures covered by PA#3 and PA#4 are expected to have limited distributional effects, as they are expected to affect mostly non-poor households (especially, in the case of measures affecting public employees) or have negligible direct impacts.

Pillar 2 is expected to have positive distributional impacts, including advancements in gender equality. While reforms to the electricity market (PA#6) are not expected to affect poverty and inequality in the short run, positive effects could be expected in the medium and long run. This could occur through increased private sector investment in electricity generation projects, reduced generation costs, improved energy efficiency, and job creation. Reforms that promote the Violet Economy (PA#7) are expected to have positive distributional effects and reduce poverty, particularly through the advancement in gender equality. Mandating larger firms to diagnose potentially discriminatory practices in recruitment, promotion, and remuneration, as well as certifying them for their demonstrated standards in fostering gender equality in the workplace, will enhance economic opportunities for women. Policy shifts regarding public-private partnerships (PA#5) are not expected to have any direct significant distributional impacts in the short run. However, they could have positive effects in the long run through job creation.

Environmental, Forests, and Other Natural Resource Aspects

Measures supported under Pillar 1, aiming to increase fiscal revenues through the proposed DPF, are expected to have overall positive effects on the environment, forests, or other natural resources. The proposed policy reforms under PA#2 aim to enhance a low-carbon development by gradually removing gasoline subsidies and establish a price smoothing formula is expected to incentivize more efficient fuel use and alternative low-carbon development and GHG emissions offset to ensure carbon neutrality. Actions proposed under PA#1 related to the VAT rate, PA#3, which aims to set a ceiling for tax expenditures of new investment contracts, and PA#4 related to salary caps are expected to have neutral effects.

Policy measures supported by Pillar 2 are expected to have, overall, positive effects on the environment, forests, or other natural resources. Positive long-term effects on Ecuador's environment are anticipated from PA5, which relates to fostering a PPP regime that includes sustainability principles and prevents activities that might harm the environment. Similarly, positive effects are expected from PA 6, which aims to unlock greater investment in renewable generation capacity and facilitate reduced energy consumption to prevent future electricity crises. This is expected to result in more efficient resource use and a reduction in energy consumption. While potential adverse effects on the environment might arise from PPP projects implementation, and the increased renewable energy capacity and potential associated infrastructure, Ecuador has a robust regulatory system, as outlined in the Environmental Organic Code, No. 983, 2017 (articles 172 to 190), to ensure appropriate environmental impact assessment and management. In addition, a recent Overview Assessment (technical assistance) on EIA conducted by the World Bank concluded that environmental management annual reports are mandatory for projects or activities of medium and high impact. The operator is obliged to comply with the approved content of the environmental audit (Art. 207 COAM). If control and monitoring mechanisms identify non-compliances, the operator must submit an action plan to mitigate them. As with other countries in the Region, the Environmental Authority faces limitations regarding staff capacity, structured procedures, and standardized criteria for reviewing complex documents such as EIAs, resulting in delays. It was recommended that these aspects be strengthened to ensure timely responses and efficiency within the EIA process which presents an opportunity for World Bank support going forward. PAs 7, is expected to have a neutral impact on the environment as they support the incentivization of women's participation and gender equality in the workplace.

G. Risks and Mitigation

The overall risk of this operation is *substantial*. Key risks include political and governance risks, macroeconomic risks, institutional capacity, and stakeholder risks, some of which cannot be fully mitigated. Specific risks, along with mitigation measures, are discussed below.[9]

Political and governance risks are *high*. As the February 2025 parliamentary and presidential elections approach, political activities are expected to escalate, potentially impacting the pace and direction of reforms. Although there is a general consensus among parliamentarians and prospective government officials on the importance of macroeconomic stability and structural reforms, their approaches may vary. One-third of the reforms supported in this DPF (PA#1, PA#5, PA#6) were passed by the Assembly, where the government holds a minority. A key stabilizing factor is the widespread endorsement of the reform program backed by international institutions such as the IMF, World Bank, IDB, and CAF, along with its macroeconomic framework. To foster public understanding and support for these reforms, the government is proactively engaging in consultations and implementing communication strategies. In this effort, the World Bank is contributing through the ESMAP Trust Fund by aiding in the development of communication strategies for fuel subsidy reforms.

Macroeconomic risks are *substantial*. Increasing international interest rates, a slower-than-expected economic recovery, natural disasters, and lower commodity prices could lead to lower than expected private investment and revenue collection. Although the GoE is committed to improving the fiscal balance and investment climate, the materialization of these risks could prevent the country from achieving its result indicators targets within the projected timeframe. Therefore, the residual risk is assessed as *substantial*.

Institutional implementation capacity risks are *substantial*. The GoE is deeply committed to the proposed program, but implementation capacity is low. The authorities have mobilized technical assistance, including from the World Bank, in many areas supported by this operation to mitigate these risks. This includes the design of the expansion of social assistance, the incidence analysis of fuel subsidy reform, tax expenditure analysis, and the design of the National Energy Efficiency Investment Fund. Other multilateral donors have also provided significant technical support. The WB's dialogue is supported by and closely coordinated with the IMF, IADB, and CAF to avoid duplication and enhance synergies.

Stakeholder risks are *substantial*. Although the selection of Prior Actions has factored in local political economy considerations, political and social tensions can adversely affect successful implementation of the overall GoE reform agenda. For instance, previous fuel subsidy reforms posed challenges due to social tensions. This operation seeks to mitigate stakeholder risks by assessing the scope of potential opposition extending beyond the specific operation. The GoE mitigates these risks through consultations to ensure that critical reforms are well communicated and understood.

[9] There are allegations of forced labor in the production of solar panels and components. This DPF focuses on policies and institutional reforms in Ecuador. DPF proceeds are not earmarked to any specific purpose, including the manufacture or procurement of solar panels or components.

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