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# en breve



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## POVERTY IN ECUADOR

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### Macroeconomic developments and poverty

Between 1980 and 2001, Ecuador's real GDP grew at 2 percent annually, slower than population growth and among the lowest in Latin America. Real GDP *per capita* declined by half a percentage point per year between 1980 and 1990 and remained almost constant afterwards. The main reason for poor performance is not external shocks—volatile oil prices and capital flows and natural disasters, or even poor economic management (fiscal deficits and monetary surprises) but weak productivity growth. Throughout 1980-2002, GDP moved hand in hand with Total Factor Productivity (TFP) – a measure of economic efficiency or productivity that captures the quality of inputs, institutions, and various economic policies. Negative TFP growth rates offset positive labor and capital accumulation, dragging growth rates down.



Policies to maintain stability with fiscal discipline and increase economic productivity and competitiveness hold promise for promoting positive, sustained growth. Fiscal income could be made less dependent on oil revenues by improving compliance and collection effectiveness of non-oil tax revenues and modifying the way the oil-price stabilization fund is managed. Less pre-allocation and earmarking of revenues would increase spending flexibility, although key program allocations, such as certain social and pro-poor programs, need to be ensured. Several fiscal policies could improve the efficiency with which resources are used, including: harmonizing and simplifying the tax system by repealing some minor taxes while simplifying and strengthening business, income and sales taxes; and eliminating various public enterprise subsidies that artificially protect against competitive forces and discourage accountability and efficiency.

### The 1998/99 crisis, the 2000 dollarization and their effect on poverty

The 1998/99 macroeconomic crisis had devastating and lasting effects, particularly in rural areas in the Costa hurt by El Niño, and among the urban middle-class. In the short run, adopting the US dollar as the national currency in response to the crisis helped control inflation. It caused prices of tradable goods to decline relative to non-tradable goods, and prices of durable goods (many of which are imported) to fall relative to non-durable goods. The resulting lower cost of the average consumption basket benefited non-poor households especially— their consumption basket, comprising 46 percent durable goods, fell in cost by 19 percent compared to only 2 percent for poor households. The medium term effects of dollarization on growth, consumption and poverty are still uncertain.

### Characteristics of the poor and poverty trends, 1990-2001

From 1990 to 2001, national consumption-based poverty rose from 40 to 45 percent, and the number of poor people increased from 3.5 to 5.2 million.<sup>1</sup> Poverty increased by over 80 percent in urban areas in the Costa and Sierra, was stable in the rural Costa and rose 15 percent in the rural Sierra.

Poverty rates continued to be highest in rural areas, but rapid urbanization increased the number of poor people living in urban areas from 1.1 million to 3.5 million, more than in rural areas. This poses challenges for urban job creation and income generation and basic service provision. Moreover, people will continue to migrate if large urban-rural income and poverty differentials persist, exacerbating these pressures.

Poor people live in larger households, are less educated, have higher unemployment and lower access to basic services. High poverty rates among indigenous and Afro populations and among women are linked to poor endowments—education (especially in urban areas) and low access to land and or access to low-productivity land in rural areas. A dearth of reliable and consistent quantitative information on ethnic groups is a barrier to designing effective policies targeted to these groups. Ethnic identification questions should be included in all surveys and other institutions.

**Urban poverty, labor market dynamics and employment creation**

Employment is the main income source, frequently the only one, for most urban families. Thus policies that generate employment and wage income are crucial for reducing urban poverty. The 1998/99 crisis sent employment and real labor income plummeting, urban poverty rose, and poor urban households resorted to various coping strategies, such as increased labor force participation and migration. Poverty declined slowly after 2000, reflecting weak formal employment creation (Table 1).

**Table 1 - Labor market trends were sensitive to the 1999 crisis and the 2000 dollarization**

	1997	1998	1999	2000	2001	2002
<b>Labor Force Participation</b>	<b>56.8</b>	<b>58.5</b>	<b>60.2</b>	<b>57.5</b>	<b>63.6</b>	<b>58.5</b>
Male	71.1	71.8	73.2	70.4	74.5	70.3
Female	43.3	46.2	48.0	45.2	53.0	46.9
<b>Employment Rate</b>	<b>90.8</b>	<b>88.5</b>	<b>85.6</b>	<b>91.0</b>	<b>89.1</b>	<b>90.8</b>
Male	93.3	92.1	89.7	94.0	93.2	94.7
Female	87.6	84.4	80.7	87.2	84.1	87.0
<b>Unemployment Rate</b>	<b>9.2</b>	<b>11.5</b>	<b>14.4</b>	<b>9.0</b>	<b>10.9</b>	<b>9.2</b>
Male	6.6	7.8	10.2	5.9	6.7	5.2
Female	12.4	15.5	19.2	12.7	15.8	12.9
<b>Hourly labor income (2000 US\$)</b>	<b>1.06</b>	<b>0.72</b>	<b>0.48</b>	<b>0.55</b>	<b>0.70</b>	<b>0.83</b>
Male	1.08	0.74	0.52	0.59	0.77	0.95
Female	1.03	0.68	0.44	0.48	0.60	0.64

**Labor productivity, employment creation and urban poverty**

Employment creation, especially formal employment creation, is closely linked to labor productivity improvements. Productivity improvements depend on the quantity and quality of inputs used in production, and the institutional framework in which firms operate. The extent to which the poor benefit from job creation depends on whether they have the skills firms need.

Exposure to international competition and access to better technologies are correlated with higher labor productivity and employment. Exporting firms and firms with access to foreign

technology are 30 percent more productive. Each 10 percent increase in labor productivity generates a 1 percent increase in employment; each 10 percentage points increase in the share of educated workers is correlated with 5 percent higher productivity.

Labor productivity and employment generation could be increased through:

- Ratifying free trade agreements and rationalizing and reducing tariffs and non-tariff barriers to help eliminate the anti-export bias associated with years of import substitution policies.
- Simplifying licensing agreements and promoting foreign direct investment, combined with effective property rights and patent protection.
- Investments in secondary education and radical reform of Ecuador’s public training institute, SECAP, and stimulating competition in training provision.

The poor are less educated and tend to be employed in small, informal firms with low access to technology. So explicit pro-poor measures are needed to:

- Promote linkages between large and small firms to help distribute the gains associated with access to foreign markets and technology, transfer technology to small firms, while providing large firms with additional degrees of flexibility.
- Create service centers or small-firm incubators that enable small businesses to share cost of a technology or service.
- Create incentives and special training programs for informal worker training.

Institutional constraints or uncertainty can inhibit labor productivity increases from generating new jobs. The Investment Climate Survey (2002) found that most firms in Ecuador would like to hire more permanent workers but are deterred by high firing costs and non-wage costs. Costly and scarce credit, poor infrastructure, and uncertainty about the economic and institutional environment appear to be the main constraints to business expansion. Forty percent of surveyed firms declared having trouble finding qualified labor, more than 60 percent reported being forced to reconsider expansion plans due to lack of credit, poor public utility provision, and economic and institutional uncertainty. There is a clear need to reform labor legislation to remove disincentives to permanent hiring, and consider special contractual forms, such as apprenticeship or re-entry contracts for vulnerable, hard-to-employ groups. Credit access could be improved through credit unions sponsored by “gremios” (industrial associations) or Chambers of Commerce, and promoting venture capital enterprises and linkages between large and small firms.

## Rural poverty, agricultural productivity, and land distribution

Forty percent of Ecuador's population lives in rural areas, 60 percent of whom are poor. The rural poor tend to work in agriculture, have limited or no access to land, and work low-productivity land. Policies to increase agricultural productivity and access to land hold promise for reducing rural poverty.

Each 1 percent rise in agricultural output increases per capita consumption 0.16-0.30 percent among households whose head is self-employed in agricultural – almost a one-to-one increase for the average rural households with 4 or 5 members. For agricultural laborers, a 1 percent increase in agricultural productivity increases wages by 0.10-0.30 percent.

Simulations of the potential impact of various policy interventions aimed at increasing agricultural efficiency—including access to credit, formal and agricultural technical education, markets and sale intermediaries; use of fertilizer and pesticides; and technical assistance—show that access to credit and agricultural education have the largest impact on small-farm productivity. Access to rural credit could be enhanced by strengthening existing small savings and loans cooperatives and women's credit groups (cajas solidarias), and allowing family assets, such as land and livestock, to be used as collateral. Access to technical assistance and agricultural education could be increased by supporting the National Institute for Training of Rural Farm Workers (Capacitación Campesina), operated by the Ministry of Agriculture in a fairly decentralized fashion, as well as agricultural research and development initiatives.

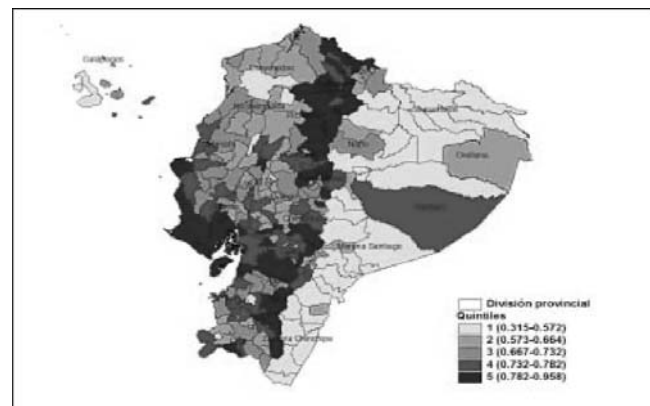
Farms of all sizes in a particular canton tend to have similar productivity levels, so targeting policy interventions to cantons with low productivity and high poverty, could be effective in decreasing poverty (Table 2).

	Small-scale farms	Medium-scale farms	Large-scale farms
Cobb-Douglas production function estimates			
Labor	0.05	0.17	0.45
Capital	0.08	0.07	0.08
Non-irrigated land	0.14	0.04	0.08
Irrigated land	0.14	0.00	0.08
Input use on non-irrigated land	0.72	0.77	0.37
Input use on irrigated land	0.40	0.70	0.39
Scale (Irrigated land)	0.99	1.04	0.99
Scale (Non-irrigated land)	0.67	0.94	1.01

## Land distribution and rural poverty

In Ecuador, as elsewhere in Latin America, land distribution is very inequitable (Figure 1). This reflects historical legacy, and legal and economic barriers to well functioning land markets. Ecuador has one of the most rigid land markets in Latin America (FAO 2002), exacerbating inequity and inefficiency. Policies to improve land market functioning in rural Ecuador are critical, especially to promote tenure security and facilitate land transactions. Specific measures needed are: removing legal and other barriers to land titling, updating land registries, eliminating uncertainty about the threat of land expropriation, implementing an effective system for resolving land disputes, removing blanket restriction against share-cropping and other rental restrictions and transferability restrictions, and designing standard land rental contracts to reduce transaction costs.

**Figure 1 - Land distribution**



## Social services and the poor

Ecuador's health and education outcomes are low relative to international standards, even after controlling for differences in development levels. Infant mortality, at 43/1000, is 10 points higher than the predicted level. Chronic malnutrition (wasting and stunting) is also above its predicted level. Results are mixed for education outcomes: relatively good for primary enrolment, average for secondary enrolment.

Outcomes vary significantly across provinces, correlated with, but not fully explained by poverty differences. Provinces in the Sierra under-perform in health; provinces in the Costa under-perform in education. This requires careful decisions about targeting and where and how to invest (additional) social sectors expenditures.

### Social expenditures: Trends and cyclicity

Ecuador's relatively poor social outcomes probably result from low, highly volatile social expenditures and poor targeting of some expenditure. Social expenditures, especially education and health expenditures, were lower in 2002 than 1980 (Table 3). Volatile, pro-cyclical expenditures choke off

**Table 3 - Social expenditure (as a percentage of GDP) has fallen dramatically over time**

	1973	1979	1981	1984	1988	1992	1996	1998	2000	2002
Total	3.8	4.6	6.3	4.9	4.7	5.2	3.8	3.4	3.6	4.5
Education	3.2	3.5	4.8	3.7	3.2	3.8	2.5	2.4	1.7	2.4
Health	0.5	1.0	1.3	1.1	1.3	1.1	0.8	0.7	0.6	1.2
Social Assistance	0.1	0.1	0.2	0.1	0.2	0.3	0.5	0.2	1.3	1.0
Bono Solidario								0.0	0.8	0.4
Other	0.1	0.1	0.2	0.1	0.2	0.3	0.5	0.2	0.5	0.6

resources when they are need most, compromising continuity of social programs and effectiveness of long-term social investments (Vos et al. 2003).

Several tools could restore social expenditure levels at least to historical levels, and dampen social sector budget volatility:

- The budget management process needs improving, so that funds disburse regularly. Fiduciary contracts, as used for the Bono de Desarrollo Humano, would mitigate Treasury cash-flow problems, and guarantee that funds for (selected) social programs are available when required.
- New guidelines for using the oil-stabilization fund and revised price triggers to divert more oil revenues into the fund could provide substantial counter-cyclical funding.

Also, social expenditures could be used more effectively. Significant improvements are needed in education provision and quality, especially in rural areas. Health service coverage must be expanded and integrated better across different sub-systems and providers.

### Social expenditures: Incidence and recent initiatives to improve targeting

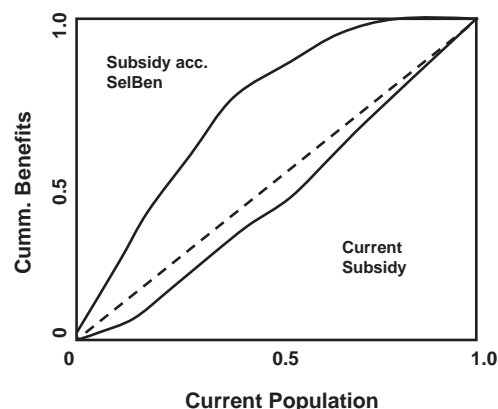
Overall, social spending is progressive (benefiting the poor relatively more than the rich), but this varies significantly across programs and services. Expenditure on primary and secondary education is progressive, both at the household and provincial level; health spending is progressive at the household level and almost neutral across provinces, with similar transfers per capita. The Bono Solidario, the largest social assistance program, is progressive, but the gas subsidy,

a large-ticket item in the government budget, benefits better-off households (Vos et al. 2003).

Social programs exhibit poor targeting, resulting in high leakage of resources to non-poor households, a key cause of their relatively low effectiveness. The Government of Ecuador has made good progress recently in improving the targeting of the Bono Solidario, now called Bono de Desarrollo Humano, but attempts to reform the gas subsidy have yet to succeed. Simulation results show that re-targeting the gas subsidy using the SelBen (a welfare index) would improve significantly on the status quo, and direct most of the spending to poor households. The poorest two quintiles would receive 44 percent of program resources instead of only 15 percent now. Re-targeting could also generate savings of up to 76 percent of the

total current subsidy—approximately US\$275 million, equivalent to 60 percent of the 2003 health sector budget and more than 4 times the education sector investment budget (Figure 2).

**Figure 2 - Re-targeting the gas subsidy using the SelBen is pro-poor and progressive**



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