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ECUADOR FISCAL ADMINISTRATION STUDIES

STAFF PAPER No. 5

FONAPAR: AN INSTITUTIONAL
ASSESSMENT

CAROLINE FAWCETT

LOCAL REVENUE ADMINISTRATION PROJECT
THE METROPOLITAN STUDIES PROGRAM
THE MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS
SYRACUSE UNIVERSITY
SYRACUSE, NEW YORK 13244-1090

JUNE 1986

ECUADOR FISCAL ADMINISTRATION STUDIES

David Greytak, Project Director

Syracuse University

SENIOR STAFF

Jorge Martinez
Kenneth Stacey

Georgia State University
Private Consultant

RESEARCH ASSOCIATES

Oakley Austin
Francisco Gonzalez
Caroline Fawcett
Hernando Garzon
Bruce Riddle

Private Consultant
Private Consultant
Johns Hopkins University
Syracuse University
Syracuse University

RESEARCH ASSISTANTS

Victor Mendez
Miguel Osio
Ramon Sarthou

Syracuse University
Syracuse University
Syracuse University

LOCAL REVENUE ADMINISTRATION PROJECT

Larry Schroeder (Public Administration) Director

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| David Greytak | Economics | Barbara Miller | Anthropology |
| Bernard Jump, Jr. | Public Admin. | Michael Wasylenko | Economics |
| William Mangin | Anthropology | | |

RESEARCH ASSOCIATES

| | | | |
|-----------------|----------------|--------------|--------------|
| Hernando Garzon | Social Science | Bruce Riddle | Data Analyst |
|-----------------|----------------|--------------|--------------|

RESEARCH ASSISTANTS

| | | | |
|------------------|----------------|---------------------|-----------|
| Mahesh Bhawe | Social Science | Ranjana Madhusudhan | Economics |
| Libby Dalton | Public Admin. | Victor Mendez | Economics |
| William Duncombe | Public Admin. | Miguel Osio | Economics |

CONSULTANTS

| | |
|-----------------|---|
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| Richard Bird | University of Toronto, Tax Policy |
| John Due | University of Illinois, Tax Policy |
| Carolyn Fawcett | Georgetown University, Public Administration |
| James Follain | University of Illinois, Tax Policy |
| William Fox | University of Tennessee-Knoxville, Tax Policy |
| Daniel Holland | M.I.T., Tax Policy |
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| Oliver Oldman | Harvard Law School, Tax Administration |
| Alek Rozental | Private Consultant, Tax Policy |
| Kenneth Stacey | Private Consultant, Customs Administration |

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THE MAXWELL SCHOOL

Guthrie Birkhead

Dean

THE METROPOLITAN STUDIES PROGRAM

Larry Schroeder
David Greytak
Roy Bahl

Public Administration/Economics
Economics
Maxwell Professor of Public Economy

Director
Assoc. Director
Senior Research Associate

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| Jerry Miner | Economics | | |

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| | | | |
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| Richard Joseph | Public Admin. | | |

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| | | | |
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FOREWORD

In Ecuador, as in many developing countries, the transfer of monies collected by the Central Government are the major source of the funds spent by municipal and provincial governments. The Fondo Nacional de Participaciones (FONAPAR) was created in 1971 for the expressed purpose of regularizing and depoliticizing the transfer of Central Government funds to municipal and provincial governments. The activities of FONAPAR and the efficiency of its operation depend crucially on a number of Government institutions including the Central Bank, the Treasury, the National Planning Board (CONADE), several autonomous government agencies, e.g., the National Development Bank (BEDE), the Pre-Investment Fund (FONAPRE) as well as various departments of the Ministry of Finance of which it is a part.

In this paper, Caroline Fawcett charts out the complexity of these interrelations and presents a detailed picture of FONAPAR's inter-relations with local governments and other central government institutions. This task alone is a valuable contribution as it sets out in bold relief the complexity of the tasks set before both FONAPAR and the nation's municipal and provincial governments. Beyond this, a number of problems and difficulties are identified. Policy options, where possible, and future research, where needed, are suggested.

Ms. Caroline Fawcett is a private consultant who in the past has worked for Georgetown University and the World Bank. This paper was prepared as part of a broader study of FONAPAR and its impact on local governments. This study, along with two others--customs reforms and restructuring of the income Tax--were undertaken simultaneously in cooperation with the Ecuadorian Ministry of Finance.

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David Greytak
Project Director
Ecuador Fiscal Administration Studies
Syracuse University
June 1986

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EXECUTIVE SUMMARY

Established in 1971, FONAPAR (Fondo Nacional de Participaciones) is a special fund of national revenues, set-aside for expenditures in municipalities, provincial councils and specific national entities. The revenue base of the program is dependent on internal tax contributions, particularly the petroleum tax contribution to FONAPAR which represents 37 percent of 1984 total revenues. The primary focus of the program is municipal finance with 70 percent of 1984 FONAPAR funds directed to municipalities. Two types of grants are available to the municipalities: the "retencion automatica" (monthly automatic payment) and the investment grant (cost-reimbursement payment). The investment grant represents an increasing percent of FONAPAR funds. In 1984, 68 percent of FONAPAR was directed to the investment grant program, and 32 percent to the "retencion automatica."

- The precarious nature of the revenue base of FONAPAR, essentially depending on oil prices, points to the need to develop local fiscal capacity to support municipal expenditures. The allocation criterion in distributing FONAPAR funds should be changed to encourage municipal revenue initiatives; under the current system, the allocation criteria are not designed to encourage local tax effort.
- The allocation formula should be rationalized to meet the underlying objectives of FONAPAR. Considerations which should be reflected in a grants' formula revision are the priorities established by the National Plan, the types of costs covered currently by FONAPAR, the enforcement capability of FONAPAR over municipal spending, and the potential growth of FONAPAR.

- In the past, the disbursements of FONAPAR have been tied to the collection of revenue from the national sources which constitute the FONAPAR fund. This procedure has made for lumpy flow of investment disbursements to the municipalities, provincial councils and others who use them. In the annual budgeting of FONAPAR, there is no schedule of payment for the investment projects funded by FONAPAR. By pre-scheduling the flow of investment funds in the FONAPAR budget, and then monitoring the flow of funds, there would be increased accountability of FONAPAR at the national level and the municipalities at the local level.
- The paperwork burden of the reporting requirements has increased substantially with the increase in the investment grant program of FONAPAR. Computerization of daily management tasks would considerably reduce these paperwork demands. Moreover, the computerization of FONAPAR accounts would allow for the Statistics Office of Budget/MOF to monitor requests made to the Central Bank to the funds actually distributed by the Central Bank. This coordination within the Budget/MOF would enable greater independence of the MOF in the administration of FONAPAR.
- The Revenue Service of the MOF and the Budget/MOF should coordinate information on revenues collected and compare their information with that generated by the Central Bank. The intra-institutional coordination would encourage greater autonomy of the MOF in the administration of FONAPAR.
- MOF and the Central Bank should coordinate their information on revenue collection and effective disbursements. There has been confusion in the past on the reporting of revenues to the Treasury which may lead to disbursement delays. Further research with Treasury, Budget/MOF, and the Central Bank should be undertaken to clarify and streamline the current reporting structure.
- A second area of concern is in the cost-reimbursement/disbursement stage of FONAPAR. Both the Budget/MOF and the Central Bank review cost-reimbursement submissions to assure that these expenditures have budget approval. No formal mechanism exists to reconcile differences between the two agencies. In fact, there is no formal notification by the Central Bank to the status of the Budget/MOF disbursement requests. There is considerable need for greater coordination between the two agencies. Through monthly meetings and daily notification, the Budget/MOF and the Central Bank Disbursement Division could encourage movement of FONAPAR funds, eliminating the delays due to duplicative functions.

- CONADE and the Budget/MOF cooperated and coordinated information in the drafting of the 1985-86 FONAPAR budget. This coordination should continue. Additionally, greater coordination between the Budget Management office of Budget/MOF and CONADE may resolve conflicts arising in the cost submissions of municipalities. One institutional alternative would be to establish an appeals board representing the interests of all three agencies (MOF, CONADE and the Central Bank) to resolve conflicts relating to the cost submissions of FONAPAR. The feasibility of such a Board of Appeals should be investigated by interviewing the appropriate offices in Budget/MOF, CONADE and the Central Bank.
- The historical autonomy of the municipalities suggests that the municipalities may not be the most able institution to mobilize resources. The political agendas of the municipalities may well undermine any local tax initiative mandated at the national level. A reorganization of FONAPAR could enhance the possibilities for local tax initiatives, for reform of municipal finance structures and for a more balanced and productive public sector.

1

FONAPAR: AN INSTITUTIONAL ASSESSMENT

Introduction

Initiated in 1971, FONAPAR (Fondo Nacional de Participaciones) was established as a special revenue fund to distribute to the municipalities and provincial councils shared tax revenue generated by the tax reform efforts of 1964-65. The tax reforms of the 1960s simplified and centralized revenue collection in Ecuador, and assigned shares of specific taxes to municipal/provincial governments. Under its original mandate (R.O. 250-6/7/71), FONAPAR was established as a special fund outside of the central government accounting framework. Expenditures of FONAPAR funds are not legislated by Congress, rather the Ministry of Finance (MOF) authorizes the FONAPAR expenditures.

The intent of FONAPAR was that it would be the only source of national government funds to the municipalities and provincial councils; and that the allocation of FONAPAR funds would be rationalized and outside of the political process. To understand the beginnings of FONAPAR, one must identify its architect, that of the military government. The extensive tax and revenue sharing reforms introduced by FONAPAR required a strong central administration. Without a military government, establishing the FONAPAR would have been most unlikely since its inception challenged the political tradition of congressional approval of public works and the tax autonomy of the municipalities.

FONAPAR in the 1980s

With the return to democracy in 1979, congressional and municipal representatives have voiced disapproval of the FONAPAR process, and

continue to undermine its effectiveness through special congressional authorizations and municipal political tugging. Additionally, the economic base of FONAPAR has changed in the last fifteen years. The FONAPAR revenue base has grown considerably due to the increase in internal tax contribution to the special FONAPAR fund. The significant growth of the fund has direct ramifications on the types of municipal expenditures supported by FONAPAR. The following summarizes the salient characteristics of FONAPAR in the 1980s.

FONAPAR has experienced tremendous growth in revenue and in expenditure (see Table 1). The annual average compound growth of total revenues for 1980-84 was 20 percent, and of total expenditures 11.32 percent. This revenue growth is due to the dramatic increase in the flow of internal taxes, primarily petroleum tax revenue and general income tax revenue into the fund. As seen from Table 1, during 1980-83, the FONAPAR fund was in deficit. The first fiscal year where FONAPAR generated a surplus was 1984. Since the beginning of the program, the deficit condition of the FONAPAR account has been covered by the central government, and has led to significant involvement by the Central Bank in the administration of FONAPAR.

The recipients of FONAPAR are the municipalities, the provincial councils and specific national government entities (i.e., universities, institutes and associations). Approximately 70 percent of the 1985-86 FONAPAR distribution flows to the municipalities. Their receipts are of two types: the "retencion automatica" (an automatic monthly payment) and the investment grant (a cost reimbursement payment). The provincial

TABLE 1
 SUMMARY OF FONAPAR REVENUE AND EXPENDITURE,
 1980-1984
 (in millions of sucres)

| | <u>1980</u> | <u>1981</u> | <u>1982</u> | <u>1983</u> | <u>1984</u> | <u>Annual Average Growth Rate 1980-1984 (in percent)</u> |
|------------------------------------|--------------------------------|-------------------|-------------------|-------------------|-------------------|--|
| Total Revenue ^a | 3,776.7 | 3,363.1 | 3,790.1 | 7,397.8 | 9,397.8 | 20 |
| Effective Expenditure ^b | 4,858.9 | 4,243.8 | 5,791.3 | 8,742.5 | 8,306.7 | 11.32 |
| "Retencion automatica" | 1,991.5 (41.0) ^c | 1,896.6 (44.7) | 2,434.4 (42.0) | 4,137.7 (47.3) | 2,673.3 (32.2) | 6.07 |
| Investment grant | 2,867.4 (59.0) | 2,347.2 (55.3) | 3,356.9 (58.) | 4,604.8 (52.7) | 5,633.3 (67.8) | 14.46 |

^aTotal revenue comprises of all earmarked FONAPAR revenues minus obligated deductions and transfers from the central government and lending agencies.

^bTotal effective expenditure is the actual disbursements issued during the fiscal year, and is distinguished by type of grant: the "retencion automatica," or automatic monthly payment, and investment, a cost-reimbursed investment grant.

^cFigures in parentheses are percent of total.

SOURCE: CONADE, Municipal Finance Division; MOF, Budget Division.

councils and national entities only receive the "retencion automatica" payment.

As Table 1 shows, the investment grants have experienced significant growth. The division of funds between these two has changed in most recent years, emphasizing the investment grant program. In 1984, almost 70 percent of FONAPAR was earmarked for investment expenditures.

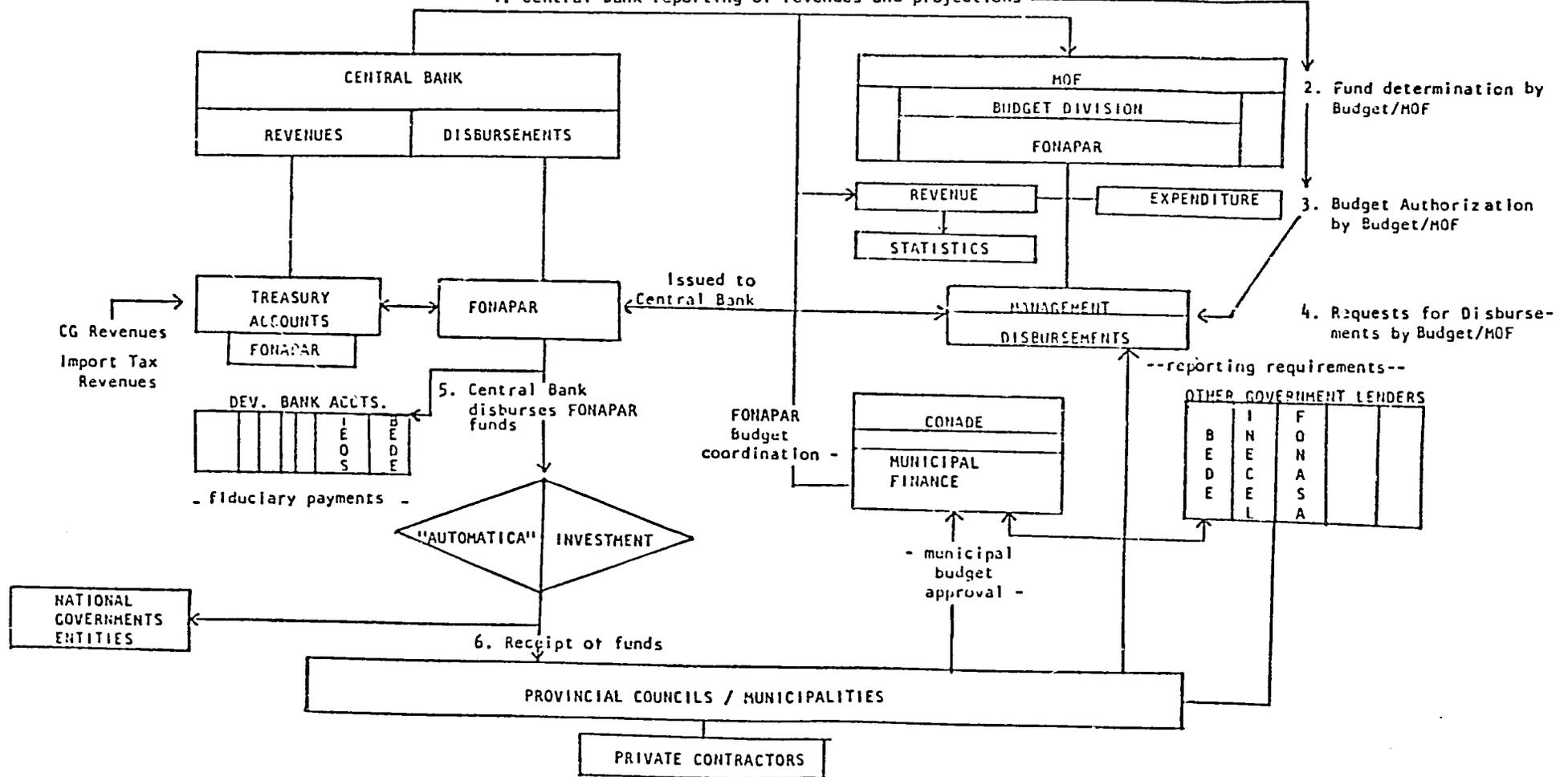
The institutional framework of FONAPAR spans across all levels of government: municipal, provincial, national government agencies, and ministries (see Figure 1). The bureaucratic home of FONAPAR is the Budget Division (Subsecretariat) of the Ministry of Finance. Budget preparation, review of cost submissions, and requests for disbursements are issued through the Budget/MOF. Yet there are a number of other institutions intricately involved in the implementation of FONAPAR:

- The Central Bank receipt and reporting of earmarked tax revenue; Central Bank projections of revenue for budget preparation purposes (step 1 in Figure 1);
- Two year fund determination by Budget Division of MOF using Central Bank statistics (step 2);
- Two year budget authorization drafted by Budget/MOF in conjunction with CONADE; Minister of Finance authorizes budget (step 3);
- Request for disbursements issued by Budget/MOF to the Central Bank. The "retencion automatica" is issued monthly; investment grants are issued upon receipt of appropriate documentation (step 4);
- Central Bank issues disbursements to recipients. Fiduciary costs covered by FONAPAR go directly to lending institution's account within the Central Bank (step 5);
- Municipalities, provincial councils and national government entities receive funds, other than fiduciary obligated payments (step 6).

FIGURE 1

INTER-INSTITUTIONAL FRAMEWORK OF FONAPAR

1. Central Bank reporting of revenues and projections



SOURCE: Based on Interviews with Budget/MOF, Central Bank, and Conade officials. Budget Plan 1985-86, MOF.

The cobweb of institutional ties of FONAPAR emphasizes the complexity of the administration of this revenue sharing program. Within each stage of FONAPAR implementation, various governmental entities are involved. Moreover, any reforms of the FONAPAR program would have serious inter-institutional consequences.

Organization of the Report

This report is organized into three main sections: Revenues, Expenditures and Institutional Relationships. The report elaborates on the above characteristics of FONAPAR and identifies problems in the administration of the program. The last section, Conclusions, provides a summary of findings, policy conclusions and additional research topics.

Revenues

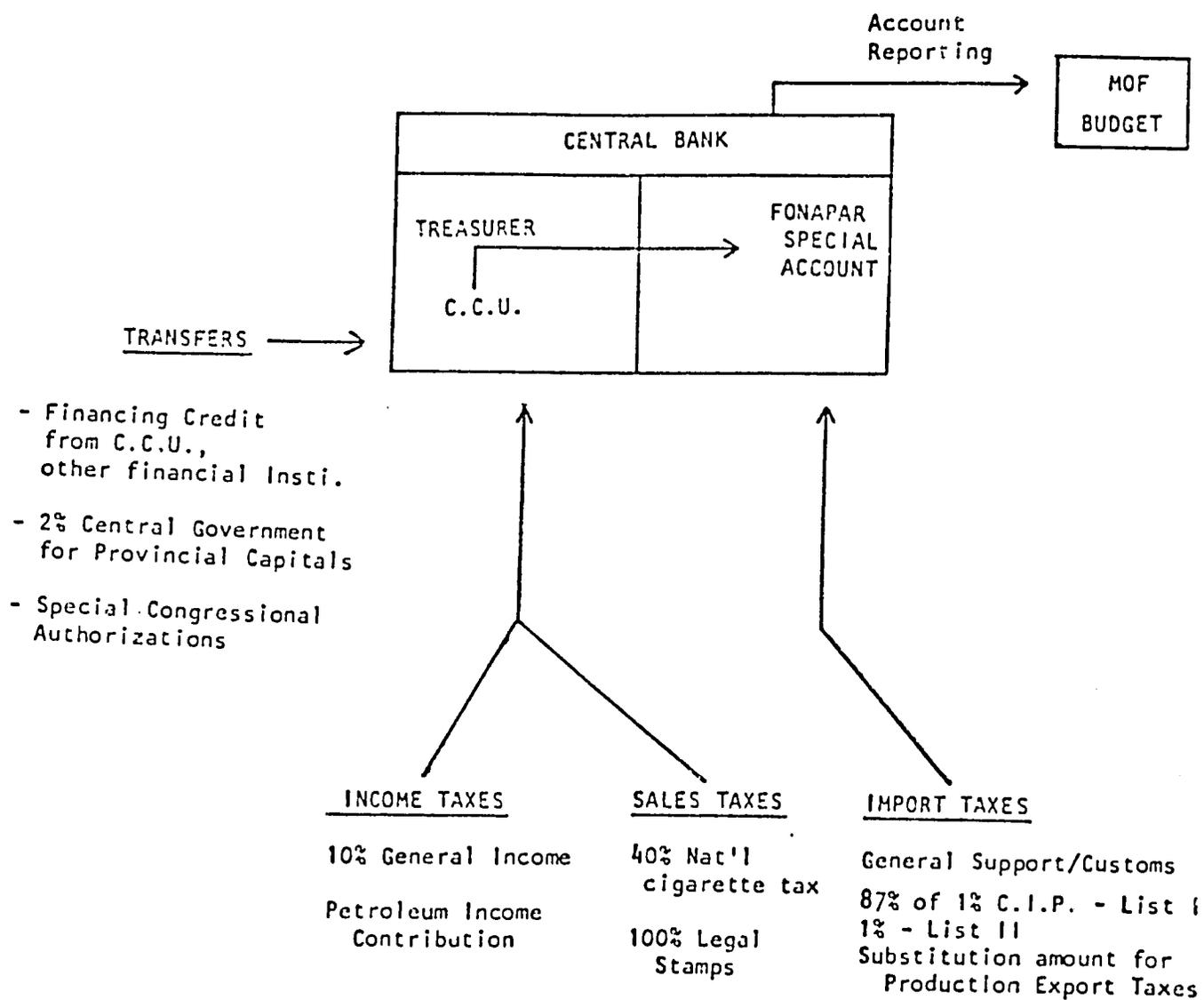
Two issues are central to the fiscal health of the FONAPAR program: stability and monthly flow of the earmarked revenues to the special FONAPAR account; and the reporting of FONAPAR revenues.

Stability of FONAPAR revenues

As Figure 2 and Table 2 illustrate, FONAPAR funds have been drawn from direct taxes, sales taxes and taxes on international trade. The revenue from the taxes on trade--currently import taxes--flow directly into the special FONAPAR account, by-passing the Central Government account (C.C.U.-Cuenta Corriente Unica). Included in this amount is a specified quota contribution from the exportation of cacao and coffee.¹ Ten percent of

¹This quota was established in 1981. For further explanation see the following section.

FIGURE 2
LECTION OF FONAPAR REVENUES



SOURCE: Budget Statistics Office, FONAPAR

TABLE 2 (CONT.)

| Items | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 ^b |
|--|--------|--------|--------|--------|--------|--------|-------------------|
| Gross Current Revenues | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Foreign Trade | 50.96 | 40.86 | 39.34 | 39.73 | 22.43 | 20.38 | 21.44 |
| Exports | 12.69 | 7.12 | 5.09 | -- | -- | -- | -- |
| Main Banana Tax | -- | -- | -- | -- | -- | -- | -- |
| 10 Percent Additional Banana Tax | -- | -- | -- | -- | -- | -- | -- |
| Main Cocoa Tax | 2.98 | 1.87 | 1.67 | -- | -- | -- | -- |
| 15 Percent Additional Cocoa Tax | 4.98 | 3.07 | 2.57 | -- | -- | -- | -- |
| Sugar Tax | 0.22 | 0.40 | -- | -- | -- | -- | -- |
| 15 Percent Additional Tax on Other Products | -- | -- | -- | -- | -- | -- | -- |
| 7 Percent Coffee Tax | 4.50 | 1.78 | 0.86 | -- | -- | -- | -- |
| Imports | 38.28 | 33.74 | 34.25 | 39.73 | 22.43 | 20.38 | 21.44 |
| Fixed Tariff Tax | 24.40 | 20.43 | 21.15 | 18.17 | 10.40 | 8.19 | 8.77 |
| .87 Percent of List I Merchandise | 11.33 | 10.39 | 10.49 | 10.73 | 6.12 | 7.80 | 7.80 |
| 1 Percent of List II Merchandise | 2.55 | 2.91 | 2.61 | 2.01 | 0.72 | 0.52 | 0.61 |
| Foreign Cigarettes | -- | -- | -- | -- | -- | -- | -- |
| Additional 1 Percent (on List I) and 6 Percent (on List II) | -- | -- | -- | -- | -- | -- | -- |
| Cocoa and Coffee Compensation | -- | -- | -- | 8.83 | 5.19 | 3.87 | 4.26 |
| Internal | 55.01 | 49.58 | 62.66 | 65.05 | 70.67 | 72.71 | 78.56 |
| Revenues | 26.12 | 23.65 | 28.45 | 52.19 | 44.68 | 40.25 | -- |
| 10 Percent General Revenue Tax | 12.88 | 13.02 | 17.87 | 15.80 | 10.89 | 11.14 | 13.40 |
| Oil Revenue Tax | 12.73 | 7.40 | 8.80 | 13.42 | 35.48 | 33.53 | 29.84 |
| Financial Transactions | -- | -- | -- | -- | -- | 1.37 | 3.05 |
| Production and Sales of Domestic Cigarettes | 11.20 | 7.34 | 9.64 | 11.11 | 9.33 | 10.06 | 12.79 |
| Fiscal Stamps | 17.68 | 21.27 | 25.74 | 24.40 | 14.97 | 16.60 | 19.49 |
| Others | 0.53 | 0.50 | 0.61 | 0.31 | -- | -- | -- |
| 4 Percent Lottery Prizes | 0.53 | 0.50 | 0.61 | 0.31 | -- | -- | -- |
| Headquarters Revenues | -- | -- | -- | -- | -- | -- | -- |
| Customs | -- | -- | -- | -- | -- | -- | -- |
| Other Tax Revenues | 0.00 | -- | -- | -- | -- | -- | -- |
| Deductions (Certificado Abano Tributario, CAT) | - 6.00 | - 5.00 | 3.00 | - 5.00 | - 1.00 | 0.00 | -- |
| Transfers | -- | 14.00 | 2.00 | -- | 8.00 | 7.00 | -- |

^aOperations began in August 1971.

^bEntries for 1985 are forecasts.

SOURCES: Data for 1971 to 1979 - Estadísticas Fiscales No. 2, Ministerio de Finanzas, Subsecretaría de Presupuesto y Crédito Público, Depto. de Estadísticas Fiscales; Data for 1980 to 1983 - computed by the author using data from Tesorería de la Nación y Banco Central; Data for 1984 and 1985 - computed by the author using data from Memorando No. SP-84-10196, sent by the Budget Subsecretary to the Minister of Finance and Public Credit.

personal income tax revenue is contributed to the FONAPAR fund. The petroleum tax is a general contribution of around S/.2,500 million, or approximately 10 percent of total petroleum tax revenue (1984). These direct tax revenues flow into the C.C.U. and are then earmarked for the special FONAPAR account in the Central Bank. Forty percent of national cigarette sales tax and 100 percent of the legal stamps revenues flow into the FONAPAR account via the C.C.U.

The transfers from the C.C.U. reflect earmarked central government expenditures and financing arrangements. Beginning in 1981, 2 percent of the central government budget has been earmarked for provincial capitals. Additional Congressional authorizations, or "special" authorizations, represent a wide range of initiatives from public works investment projects (i.e., the Napo/Esmeraldas) to the national minimum wage increase (i.e., the resultant increase in wage cost to the municipalities being covered by a special authorization). Since the resumption of Congress in 1979, the FONAPAR system has become increasingly a mechanism to earmark central government revenues to either specific expenditure items (i.e., minimum wage increase) or to specific regions (i.e., Napo/Esmeraldas).

A second purpose of the transfers from the C.C.U. is for debt servicing, or cancellation of prior loan arrangements. Since the inception of the program, the C.C.U., the Central Bank and other Ecuadorian financial institutions have provided deficit financing for FONAPAR. To a lesser extent, funds transferred from FONAPAR to lending institutions (under fiduciary arrangement) are transferred back to FONAPAR, given the cancellation of loan agreements by the municipality. One last item in the

revenue schedule of FONAPAR is that of the deductions, the Certificado Abono Tributario (CATs). These deductions represent a certified amount of the sales tax and legal stamp tax revenue which is re-directed to the municipalities. In most years, these CATs are not significant; in 1984 they represented .024 percent of the total revenue.

Change in the Composition of Funds. As Table 2 presents, the percent contributions of the earmarked taxes have changed significantly during 1971-85. Beginning in 1971, the export and import tariff fees represented approximately 68 percent of the overall contribution. The earmarked internal taxes on petroleum, general income, legal stamps, and sales tax on cigarettes represented a much smaller percentage in 1971, that of 32 percent. In 1981 (under Ley A.M. 426/427) the percent contribution of export taxes on coffee and cacao was re-established, that of a fixed contribution of S/.350 million (Compensacion de cacao y cafe). As of 1984, the import/export taxes represent only 20 percent of the FONAPAR revenue base. The export contribution which represented 58 percent of total FONAPAR income (1971), amounted to only 4 percent of the 1984 revenue contribution (as represented by the cacao and coffee contribution).

Offsetting the revenue reduction of export taxes is the dramatic increase in internal tax contributions, most particularly that of the petroleum income tax revenue. In 1971, the petroleum tax revenue contributed around 12 percent to total FONAPAR funds; in 1984, this contribution represented 34 percent. Additionally, legal stamps, sales tax on cigarettes, and the 10 percent of the general income tax contribution all have become an increasing percent of the FONAPAR revenue base. When

summing the contributions of all internal taxes, they represent 73 percent of total FONAPAR revenue in 1984.

The reliance of FONAPAR on internal taxes, and most particularly petroleum tax income, challenges the stability of the FONAPAR program. Given the volatility of oil prices, and in most recent years, the decline of world oil prices, FONAPAR will face increasing fiscal constraint. A second observation relates to internal taxes. The focus of FONAPAR is municipal finance and investment, yet FONAPAR receives only 10 percent of its total revenue from sales taxes, and a fractional percentage from lotteries, both could be considered as possible municipal tax revenues.

Although legally, expenditures are not to exceed revenues, the sum of FONAPAR allocation frequently exceeds its revenues. The resulting deficit has required special transfers from the central government to FONAPAR. The recurrent deficit suggests a spending program which lacks checks or balances. The primary objective of the program--investment in local public works projects--could ultimately be at least partially self-financing, i.e., funded in some measure by the increased revenue generated by the public investment. Under the current revenue structure, FONAPAR primarily is dependent on world-wide oil prices and accountability between revenue and expenditure is not built into the program.

Flow of Funds. A commonly held view in the MOF is that the irregular flow of funds has been a major obstacle in implementing FONAPAR. Let us first examine the flow of the specific revenue sources for 1981 and 1984 (see Tables 3 and 4). In 1981 the greatest fluctuation is observed for the internal taxes, and particularly for the general income and the

TABLE 3

1981 MONTHLY FLOWS AS A PERCENT OF THE AVERAGE
ANNUAL FLOW AND STANDARD DEVIATION OF
ANNUAL FLOW BY REVENUE SOURCE

| | Annual Average Flow (thousands of sucres) | Monthly Flows as Percent of Annual Average Flow | | | | | |
|-------------------------------------|---|--|------|-------|-------|------|------|
| | | Jan. | Feb. | March | April | May | June |
| Gross Current Income | S/.289,264.5 | .93 | .79 | .86 | 1.49 | .84 | .84 |
| 10 Percent General Income Tax | 50,688.3 | 1.43 | .88 | 1.85 | .82 | .49 | .52 |
| Legal Stamp Tax | 73,007.8 | .95 | .74 | .84 | 1.09 | .88 | 1.02 |
| 4 Percent National Cigarettes | 27,326.3 | .97 | 1.24 | 1.21 | .60 | .50 | 1.23 |
| 87 Percent of 1 Percent - List 1 | 29,742.0 | .57 | .88 | 1.13 | .91 | 1.00 | 1.01 |
| 1 Percent - List 2 | 7,289.7 | .62 | .92 | .98 | 1.01 | .96 | 1.21 |
| Petroleum Contribution | 24,950.7 | .42 | 1.86 | .42 | 1.25 | 1.46 | 1.93 |
| Import Tax | 6,000.0 | 1.00 | -- | -- | 3.00 | 1.00 | -- |

| | Monthly Flows as Percent of Annual Average Flow | | | | | | Standard Deviation of Annual Flow (percent of average) |
|-------------------------------------|--|------|-------|------|------|------|--|
| | July | Aug. | Sept. | Oct. | Nov. | Dec. | |
| Gross Current Income | 1.31 | .80 | 1.32 | .74 | .89 | 1.19 | .24 |
| 10 Percent General Income Tax | 1.54 | .73 | 1.11 | .73 | 1.04 | .85 | .40 |
| Legal Stamp Tax | 1.15 | 1.12 | 1.25 | 1.02 | .98 | .92 | .14 |
| 4 Percent National Cigarettes | 1.45 | .98 | .88 | .69 | .61 | 1.63 | .34 |
| 87 Percent of 1 Percent - List 1 | 1.15 | .96 | .90 | 1.02 | .92 | 1.53 | .21 |
| 1 Percent - List 2 | 1.23 | .99 | 1.12 | .87 | 1.14 | .94 | .16 |
| Petroleum Contribution | .04 | 1.24 | 1.04 | 1.12 | .63 | .57 | .57 |
| Import Tax | 2.00 | -- | 2.00 | -- | 1.00 | 2.00 | 1.00 |

SOURCE: MOF, Central Division of Budget Statistics.

TABLE 4

1984 MONTHLY FLOWS AS A PERCENT OF THE AVERAGE
ANNUAL FLOW AND STANDARD DEVIATION OF
ANNUAL FLOW BY REVENUE SOURCE

| | Annual Average Flow (thousands of sucres) | Monthly Flows as Percent of Annual Average Flow | | | | | |
|-------------------------------------|---|--|------|-------|-------|------|------|
| | | Jan. | Feb. | March | April | May | June |
| Gross Current Income | S/. 674,110.3 | 1.08 | .86 | 1.24 | .79 | 1.13 | .98 |
| 10 Percent General Income Tax | 81,652.6 | .76 | .62 | 2.63 | .68 | .52 | .42 |
| Legal Stamp Tax | 1,215,389.8 | .84 | 1.10 | 1.09 | 1.12 | 1.33 | 1.35 |
| 4 Percent National Cigarettes | 73,733.3 | .99 | .99 | .99 | .99 | .99 | .99 |
| 87 Percent of 1 Percent - List 1 | 57,153.9 | 1.03 | 1.02 | .90 | .82 | .89 | 1.02 |
| 1 Percent - List 2 Petroleum | 3,801.1 | 1.33 | 1.37 | 2.03 | 1.09 | -.22 | .04 |
| Contribution | 245,586.2 | 1.36 | .62 | 1.13 | .52 | 1.41 | .97 |
| Import Tax | 86,333.3 | 1.02 | 1.02 | .90 | 1.02 | 1.02 | 1.02 |

| | Monthly Flows as Percent of Annual Average Flow | | | | | | Standard Deviation of Annual Flow (percent of average) |
|-------------------------------------|--|------|-------|------|------|------|--|
| | July | Aug. | Sept. | Oct. | Nov. | Dec. | |
| Gross Current Income | 1.22 | .56 | .89 | 1.27 | 1.11 | .76 | .21 |
| 10 Percent General Income Tax | 1.64 | .82 | 1.14 | .83 | 1.27 | .65 | .58 |
| Legal Stamp Tax | 1.50 | -.32 | 1.21 | 1.18 | 1.16 | .43 | .48 |
| 4 Percent National Cigarettes | .99 | .99 | .99 | .99 | .99 | 1.11 | .03 |
| 87 Percent of 1 Percent - List 1 | .70 | .80 | 1.16 | 1.25 | 1.18 | 1.21 | .17 |
| 1 Percent - List 2 Petroleum | .86 | .55 | 1.05 | .38 | 1.58 | 1.93 | .68 |
| Contribution | 1.58 | .56 | .78 | 1.29 | 1.07 | .69 | .35 |
| Import Tax | -- | 1.02 | 1.02 | 2.04 | 1.02 | .91 | .42 |

SOURCE: MOF, Central Division of Budget Statistics.

petroleum tax contributions. The 1984 monthly flows of income tax revenues were significantly higher with the weighted standard deviation at 58 percent. In contrast, the petroleum revenue deviation stood in the 35 percent deviation range. Given the increasing reliance of FONAPAR funds on internal taxes, these findings are foreboding news. When examining the revenue flows in the monthly aggregate, the fluctuation is not as dramatic, with the weighted standard deviation of gross current income monthly flows being around 20.25 percent. Only in the month of August 1984 is there a serious decline in overall revenues. Comparing the aggregate monthly flows in 1981 and 1984, the fluctuation is larger in 1981, but by only three percentage points.

In addressing the question of whether the fluctuations in revenues undermine the disbursement of FONAPAR funds, it is necessary to observe revenue-expenditure flows concurrently (see Table 5). Several observations can be made. The large disbursement in January represents past year budget commitments. The March disbursement reflects disbursement under the new fiscal year. Thirdly, approximately 60 percent of FONAPAR funds are distributed in August-December of 1984. During this same time period, around 40 percent of annual revenues flow into the FONAPAR account.

The fiscal health of FONAPAR is best represented by the surplus/deficit condition of the account. In these terms, the monthly financial status of FONAPAR has been quite volatile. Monthly balances ranged from a deficit of S/.437.8 million in August and a surplus of S/.390.3 million in October. While the monthly flows suggest significant swings in revenues, expenditures are not victim to such extreme fluctuation.

TABLE 5

FONAPAR - MONTHLY COMPARISON OF THE
STATE CASHIER TRANSACTIONS: 1984
(in thousands of sucres)

| | Jan. | Feb. | March | April | May | June | July | Aug. |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| TOTAL REVENUES | S/.753,011.8 | S/.563,117.7 | S/.838,201.3 | S/.533,609.8 | S/.789,985.4 | S/.657,964.1 | S/.868,697.9 | S/.410,799.8 |
| Current Net Income | 726,011.8 | 563,117.7 | 835,387.2 | 533,809.8 | 763,236.4 | 657,964.1 | 921,590.1 | 377,074.0 |
| Gross Current Income | 726,334.2 | 563,237.5 | 836,482.6 | 530,836.6 | 763,233.9 | 658,066.0 | 921,893.4 | 377,159.4 |
| Traditional | 391,896.6 | 410,944.2 | 559,837.3 | 402,715.1 | 417,462.3 | 419,377.3 | 433,234.4 | 238,958.3 |
| Petroleum | 334,437.6 | 152,293.3 | 276,645.3 | 128,121.5 | 345,776.6 | 238,688.7 | 388,659.0 | 138,201.1 |
| Minus CAT's | 322.4 | 119.8 | 1,095.4 | 26.8 | 2.5 | 101.9 | 303.3 | 85.4 |
| Transfers ^a | 27,000.0 | -- | 2,814.1 | -- | 26,750.0 | -- | 18,625.0 | 18,624.9 |
| 60 Percent of the SLD ^b | -- | -- | -- | -- | -- | -- | 28,482.8 | 15,100.9 |
| Passive Differences | -- | -- | -- | -- | -- | -- | -- | -- |
| TOTAL EXPENDITURES | 653,606.4 | 574,484.8 | 854,026.8 | 540,305.4 | 497,865.2 | 575,126.6 | 408,789.6 | 848,581.4 |
| Current Period | 25,977.7 | 270,369.8 | 849,196.8 | 540,305.4 | 497,865.2 | 575,126.6 | 408,789.6 | 848,581.4 |
| Prior Period | 627,628.7 | 304,115.0 | 4,830.0 | -- | -- | -- | -- | -- |
| DEFICIT (-) SURPLUS (+) | (+) 99,405.4 | (-) 11,367.1 | (-) 15,825.5 | (-) 6,495.6 | (+)292,121.2 | (+) 82,837.5 | (+)459,908.3 | (-)437,781.6 |
| FINANCING (+), UTILIZATION (-) | (-) 99,405.4 | (+) 11,367.1 | (+) 15,825.5 | (+) 6,495.6 | (-)292,121.2 | (-) 82,837.5 | (-)459,908.3 | (+)437,781.6 |
| Utilization of Current Account Resources | (-) 37,495.6 | (+) 8,310.6 | (-) 72,740.4 | (+)135,734.4 | (-)135,360.9 | (-)228,260.7 | (-)389,333.7 | (+)367,607.4 |
| Cashier and Bank Balance | (-) 61,909.8 | (+) 3,056.5 | (+) 88,565.9 | (-)129,238.8 | (-)156,760.3 | (+)145,423.2 | (-) 70,574.6 | (+) 70,174.2 |
| Initial | 89,608.1 | 151,517.9 | 148,461.4 | 59,895.5 | 189,134.3 | 345,894.6 | 200,471.4 | 271,046.0 |
| Minus Final | 151,517.9 | 148,461.4 | 59,895.5 | 189,134.3 | 345,894.6 | 200,471.4 | 271,046.0 | 260,871.8 |

TABLE 5 (CONT.)

| | <u>Sept.</u> | <u>Oct.</u> | <u>Nov.</u> | <u>Dec.</u> | <u>Through Dec. 31</u> |
|----------------------------------|--------------|--------------|--------------|--------------|----------------------------|
| TOTAL REVENUES | S/.964,368.5 | S/.994,294.2 | S/.834,034.8 | S/.582,061.1 | S/.8,790,346.4 |
| Current Net Income | 666,027.8 | 856,203.5 | 745,448.4 | 514,362.2 | 8,060,233.0 |
| Gross Current Income | 666,031.1 | 856,206.9 | 745,459.3 | 514,381.6 | 8,062,324.5 |
| Traditional | 473,438.0 | 538,175.1 | 481,469.8 | 344,660.9 | 5,115,169.3 |
| Petroleum | 192,593.1 | 318,031.8 | 263,986.5 | 169,720.7 | 2,947,155.2 |
| Minus CAT's | 3.3 | 3.4 | 7.9 | 19.4 | 2,091.5 |
| Transfers ^a | 285,290.7 | 123,392.6 | 54,958.3 | 52,144.4 | 609,600.0 |
| 60 Percent of the SLDQ | | | | | |
| Passive Differences ^b | 13,050.0 | 14,698.4 | 33,628.1 | 15,553.6 | 120,513.4 |
| TOTAL EXPENDITURES | 842,138.9 | 603,996.5 | 856,974.3 | 1,000,289.7 | 8,256,135.6 |
| Current Period | 842,138.9 | 603,996.5 | 856,974.3 | 1,000,289.7 | 7,319,611.9 |
| Prior Period | -- | -- | -- | -- | 936,573.7 |
| DEFICIT (-) SURPLUS (+) | (+)122,229.6 | (+)390,297.7 | (-) 22,939.5 | (-)418,229.6 | (+) 534,160.8 |
| FINANCING (+), | | | | | |
| UTILIZATION (-) | (-)122,229.6 | (-)390,297.7 | (+) 22,939.5 | (+)418,229.6 | (-) 534,160.8 |
| Utilization of Current | | | | | |
| Account Resources | (-)161,872.7 | (-)216,001.9 | (-) 63,681.2 | (+)445,389.5 | (-) 347,705.2 |
| Cashier and Bank Balance | (+) 39,643.1 | (-)174,295.8 | (+) 86,620.7 | (-) 27,159.6 | (-) 186,455.6 |
| Initial | 200,871.8 | 161,228.7 | 335,524.5 | 248,903.8 | 89,608.1 |
| Minus Final | 161,228.7 | 335,524.5 | 248,903.8 | 276,063.7 | 276,063.7 |

^aTransfers according to the Ministerial Agreement No. 300 of April 26, 1983.

^bContribution for the provinces of Napo and Esmeraldas, according to the Legislative Decree No. 162 of April 27, 1984.

SOURCE: Central Bank, National Treasury and Central Bureau of Budget Statistics.

Table 6 provides a summary of 1980-84 financial status of FONAPAR. The first year of surplus of the FONAPAR account was 1984. Before 1984, deficit financing through transfers from the C.C.U., the Central Bank and other financial institutions covered the FONAPAR overdraft. Beginning with the start of the program in 1973, the annual C.C.U. transfer was a short-term credit simply to cover the previous year's deficit. The solvency problem was attributed to the irregular flow of tax revenue. To resolve the flow of funds problem, beginning in 1981, the 2 percent earmark of Central Government revenue is transferred into the FONAPAR account at the beginning of each fiscal year, supposedly resolving the monthly flow problem. Given the data in Table 5, this transfer is not sufficient to keep the FONAPAR monthly account in surplus. Also, such bookkeeping techniques cannot resolve the simple fact that FONAPAR expenditures have been greater than revenues in all years, except for 1984-85. Under the legislative guidelines of FONAPAR, the program cannot legally overspend its allotment. The continual deficit condition of the account (except in 1984-85) suggests that neither the Central Bank, the C.C.U. (representing the central administration) nor M.O.F. officials have been responsive to this legislative mandate.

Given the evidence of Tables 3-6, one can conclude that the revenue collection peaks in July, and that the bulk of expenditure distributions span the August-December period. Lumpy flows of revenues seem to be a key consideration in the distribution of funds. Moreover, the flows of internal taxes which currently represent 73 percent of total FONAPAR revenues are subject to the greatest fluctuation. The complications

TABLE 6

FONAPAR, COMPARATIVE SUMMARY OF CASHIER
TRANSACTIONS: 1980-1984
(in thousands of sucres)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|
| TOTAL REVENUES | S/.3,482,161.9 | S/.3,417,151.8 | S/.3,971,393.4 | S/.6,923,176.7 | S/.8,790,364.4 |
| Current Net Income | 2,996,161.9 | 3,363,151.8 | 3,971,393.4 | 6,398,176.7 | 8,060,233.0 |
| Current Gross Income | 3,187,720.3 | 3,471,174.0 | 4,152,745.9 | 6,448,574.1 | 8,062,324.5 |
| Traditional | 2,926,931.7 | 3,171,765.1 | 3,620,873.9 | 3,991,039.1 | 5,115,169.3 |
| Petroleum | 260,788.6 | 299,408.9 | 531,872.0 | 2,457,535.0 | 2,947,155.2 |
| Deductions | (191,558.4) | (108,022.2) | (181,352.5) | (50,397.4) | (2,091.5) |
| Transfers | 486,000.0 | 54,000.0 | -- | 525,000.0 | 609,600.0 |
| 60 Percent of the SLDO | | | | | |
| Passive Differences ^a | -- | -- | -- | -- | 120,513.4 |
| TOTAL EXPENDITURES | 4,901,791.7 | 4,545,417.8 | 5,590,058.1 | 8,774,680.0 | 8,256,185.6 |
| Current Period | 3,789,812.2 | 3,476,334.5 | 4,822,608.9 | 7,805,932.6 | 7,319,611.8 |
| Prior Period | 1,111,979.5 | 1,069,083.3 | 767,449.2 | 968,747.4 | 936,573.8 |
| DEFICIT (-) SURPLUS (+) | (-)1,419,629.8 | (-)1,128,266.0 | (-)1,618,664.7 | (-)1,851,503.3 | (+) 534,160.8 |
| FINANCING (+) UTILIZATION (-) | (+)1,419,629.0 | (+)1,128,266.0 | (+)1,618,664.7 | (+)1,851,503.3 | (-) 534,160.8 |
| Internal | 1,394,891.7 | 1,125,177.9 | 1,588,507.6 | 1,943,800.9 | (-) 347,705.2 |
| Resource Utilization (C.C.U.) | 1,039,346.0 | 1,118,511.2 | 1,588,507.6 | 1,943,467.6 | (-) 347,705.2 |
| Bond Placement Decree 3093 | 355,545.7 | -- | -- | -- | -- |
| Loan Cancellation Benefit | | | | | |
| Group | -- | 6,666.7 | -- | (-) 6,666.7 | -- |
| Cashier and Bank Balance | 24,738.1 | 3,088.1 | 30,157.1 | (-) 85,297.6 | (-) 186,455.6 |
| Initial | 62,293.8 | 37,555.7 | 34,467.6 | 4,310.5 | 89,608.1 |
| Minus Final | (37,555.7) | (34,467.6) | (4,310.5) | (89,608.1) | (276,063.7) |

^aAccording to the Legislative Decree No. 162 of April 27, 1984.

SOURCE: MOF, Central Division of Budget Statistics.

arising from variation in the flow of funds into the FONAPAR account would seem to be easily avoided. This could be accomplished without giving up the tie between the proceeds of certain taxes and FONAPAR revenues. That is, the annual FONAPAR appropriation could be determined as it now is on the basis of the projected proceeds from the shared tax sources. Funds then could be transferred to FONAPAR from the central government's general account according to the most appropriate schedule, subject to an annual rather than a monthly or quarterly balance of accounts.

Reporting of FONAPAR Revenue

The Central Bank is the comptroller of the FONAPAR account: it reports the revenue receipts, estimates FONAPAR future revenue and disburses FONAPAR funds to the municipalities. One thorny issue is the Central Bank reporting of FONAPAR revenues to the Treasury and MOF. Several interviewed MOF officials stated a problem in the Central Bank statistical reporting, that being the confusion over the percent contribution of the various shared taxes in the central government account (C.C.U.). The Central Bank reporting of collected shared taxes is imputed on total FONAPAR contributions, and does not specify the percent contribution of the various shared tax sources. With these statistics, the Treasurer, who is ultimately responsible for the transfer of FONAPAR revenues from the C.C.U., cannot distinguish by type of revenue sources, nor can he compare the imputed figure to the budgeted revenue figures--his base of comparison. The seriousness of this problem needs to be further researched, investigating sources in the Treasury and in the Central Bank. In assessing this issue, one must distinguish between the accounting

aspects of the revenue receipt in contrast to the general process of revenue reporting and program administration. One consideration is the transfer of money without receipt of revenue. This procedure is adopted by several revenue sharing programs in the United States. However, the deficit situation of FONAPAR might cast doubt on the effectiveness of this procedure.

The Office of the Program and Evaluation of Revenues within Budget/MOF is responsible for the monitoring of FONAPAR revenues, as well as estimating the revenue for budget planning purposes. The determination of the FONAPAR distribution is the first step in the budget process, and is done by estimating revenues for a two-year period. The 1985-86 projected revenue figures were estimated from 1984 data with adjustments made for each individual revenue source.

Using Central Bank actual collected revenue data, the Revenue office estimated that the increase in 1985 revenues was 3.9 percent, a modest gain given that historically annual revenue increases have been in the 25 percent range. This drop is due primarily to the fall in petroleum revenue. The use of Central Bank data, in addition to the revenue projections by the Central Bank, points to the overall dependence of the Revenue Office within the Budget/MOF Division on Central Bank statistics in estimating FONAPAR revenue. The dependence of the Budget office on the Central Bank statistical arm is most ironic, since the MOF's Revenue Service Division has similar data. Moreover, this aptly illustrates the lack of coordination between the Revenue Service and the Budget office, both branches part of the same Ministry. It can be conjectured that such

coordination would increase the autonomy of the MOF in administering FONAPAR.

Expenditures

The effectiveness of FONAPAR is largely determined by the performance of its spending program. Performance can be defined as the timeliness of funds and the capacity of FONAPAR to generate municipal investment programs in accordance with the guidelines of the National Plan. The types of grants available, the allocation of funds, and the timely disbursement of FONAPAR monies are all important performance factors. This section outlines the institutional process of authorization and disbursement, focusing on the Budget Division of the MOF, the Subsecretariat responsible for the authorization and issuance of FONAPAR expenditures. The next section will continue this discussion under a broader framework of inter-institutional ties.

Authorization of FONAPAR Funds

The expenditure authorization is a two year budget plan administered from January to December, the Ecuadorian fiscal year.² The budget includes: 1) a two year projection of revenues; 2) obligating and earmarking of specific expenditures to recipients in Year 1; and 3) obligating funds with general earmarking of the broad categories, "automatica" and investments, ("asignacion global") to recipients in Year 2. Implicit in the Year 2 allocation is the understanding that if

²Presupuestos de FONAPAR, 1983-84; 1985-86.

necessary, FONAPAR will continue to fund investment projects which received funds in Year 1. As described in the previous section, the Office of Revenue within the Budget Division, using Central Bank statistics and projections, determine the pool of FONAPAR funds which is the base calculation of the budget plan. These estimates are used by the Office of Expenditure, another subunit of the Budget Division/MOF, in drafting a two year expenditure plan.

The types and distribution of grants are organized around the recipient agency--namely, municipalities, provincial councils and national government entities. Table 7 outlines the various grants available to their respective government entities. Municipalities receive an automatic monthly grant payment, "retencion automatica," and an investment allocation which is cost-reimbursement for approved investment projects. On a monthly basis the provincial councils receive their 2 percent of central government budget revenue which is embedded into a "retencion automatica". The national government entities, consisting of educational establishments (i.e., universities and training high schools), cultural institutions and associations, receive an automatic payment to cover specific operating costs. The special congressional authorizations for 1985-86 depend on the legislative mandate for each authorization and they are part of the "other entities" categories.³

³See Table y, footnote d.

TABLE 7

EXPENDITURE SUMMARY: TYPE OF GRANT AUTHORIZATION,
ALLOCATION CRITERIA, REPORTING REQUIREMENTS,
EXPENDITURES COVERED BY AUTHORIZATION

| <u>Fund Recipient</u> | <u>Type of Grant</u> | <u>Period of Payment</u> | <u>Allocation Criteria (1984-85)</u> | <u>Reporting Requirements</u> | <u>Expenditures Covered by Authorization</u> |
|--------------------------------------|---|---|---|---|--|
| Municipalities | "retencion automatica" | Automatic monthly payment (no receipt submission necessary) | Hold-bankers policy using 1984 municipal expenditures as a base | Municipal annual submission of expenditure budgets to CONADE | Municipal administrative costs, payment of municipal public debt and fiduciary costs |
| | Investment | Cost-reimbursement schedule | Fiduciary costs represent up to 50 percent of "automatica". Population share increase. | Receipt submission of approved expenditure. Advance costs reimbursed when required documentation presented. | Enforced earmarked investment expenditures; fiduciary project advance costs |
| Provincialities | 2 Percent of Central Gov't. budget (transfers from C.C.U.) | Automatic monthly payment | 25 percent Quito, 25 percent Guayaquil, 50 percent equal share (2.7 percent to remaining 18 cities) | (N/A) | No earmarking, usually Provincial administrative and program costs |
| National Government Entities | Educational establishments (universities, institutes, and associations) | Automatic payment | | (N/A) | Fixed costs |
| Special Congressional Authorizations | | - - - - mandated by Congress in allocation and reporting requirements - - - - | | | |

SOURCE: FONAPAR Budget Plan, 1983-84, 1985-86 (MOF), Memorandum SP-84-10196.

Details of the distribution of funds by the initial, codified and effective distribution can be seen in Table 8⁴. The initial authorization of the FONAPAR budget is completed in December. The initial authorization represents the estimated amount of revenue. The final codified budget has been historically higher than the initial authorization, ranging from 50 percent higher in 1980 to 65 percent higher in 1983. The explanation given for this by MOF officials is that there is a political response to pressures for projects not included in the original budget. The 1985 codified authorization is 26 percent higher than the initial assignment. The codified budget is signed by the Minister of Finance in February-March of the fiscal year. The effective distribution, namely the funds that actually are distributed, is historically less than the codified budget, but more than the initial budget. Nonetheless, these facts indicate that the recurrent deficit in FONAPAR's budget is the result of a failure in the budget approval process which would insulate FONAPAR from the politics of favored projects and special requests.

Table 8 also details the percent receipts of municipalities, provincial councils and national government agencies. The municipal share is approximately 70 percent and is the major chunk of FONAPAR 1985-86 distribution. The provincial councils' share represent around 25 percent and the national government share is only 3 percent in the 1985-86 plan. Special authorizations in the 1985-86 plan represent 6 percent. A number

⁴The format of this table, and earlier analysis of FONAPAR has been undertaken by Lic. Renar Cisneros in "El Fondo de Participaciones y su Incidencia en la Ejecucion Presupuestaria," 1982 Ciencias Administrativas (Quito, Ecuador: Facultad de Ciencias Administrativas 1982-II).

TABLE 8

FONAPAR - DISTRIBUTION OF ALLOCATED FUNDS
TO INSTITUTIONAL GROUPS: 1980-86

| | <u>1980</u> | <u>1981</u> | <u>1982</u> | <u>1983</u> | <u>1984</u> | <u>1985</u> | <u>1986</u> |
|------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-----------------------|
| INITIAL ALLOCATION | | | | | | | |
| Total | 3,606.0 | 4,825.0 | 4,898.9 | 5,400.0 | 6,957.9 | N.A. | N.A. |
| Provincial Councils | 1,128.0 | 1,078.0 | 1,471.0 | 1,610.5 | 1,723.6 | N.A. | N.A. |
| Municipal Councils | 2,203.4 | 2,285.4 | 3,058.1 | 3,428.0 | 3,608.2 | N.A. | N.A. |
| Other Entities ^a | 274.6 | 1,461.6 | 369.8 | 361.5 | 426.1 | N.A. | N.A. |
| AUTHORIZED ALLOCATION | | | | | | | |
| Total | 5,402.4 | 4,718.3 | 6,404.9 | 8,910.3 | 8,766.9 | 9,778.0 | 10,240.0 ^b |
| Provincial Councils | 1,350.5 | 1,000.2 | 1,602.9 | 1,777.4 | 2,125.8 | 2,360.0 | 2,360.0 ^b |
| Municipal Councils | 2,981.2 | 2,083.7 | 3,496.0 | 3,576.5 | 4,433.7 | 6,910.4 | 6,910.4 |
| Other Entities ^a | 545.7 | 1,634.4 | 1,306.0 | 2,356.4 | 1,007.4 | 507.6 | 969.5 |
| ACTUAL/EFFECTIVE ALLOCATION | | | | | | | |
| Total | 4,858.9 | 4,243.8 | 5,791.4 | 8,742.5 | 8,306.7 | N.A. | N.A. |
| Provincial Councils | 1,339.7 | 909.4 | 1,586.9 | 1,746.5 | 2,036.1 | N.A. | N.A. |
| Municipal Councils | 2,594.6 | 1,858.0 | 3,056.6 | 3,441.2 | 4,129.1 | N.A. | N.A. |
| Other Entities ^a | 399.6 | 1,476.4 | 1,147.9 | 2,354.8 | 941.5 | N.A. | N.A. |

^aIncludes educational and other national government entities. In the 1985-86 codified budget, this amount includes the Napo/Esmeraldas authorization of \$(sucres)192.4 million (1985) and 662.9 million (1986).

^bIncludes the 2 percent earmarked revenues from C.C.U. to municipal governments.

SOURCE: Allocations of FONAPAR by provinces and municipalities 1980-84 based on CONADE reporting; processed by the Local Revenue Administration Project, Syracuse University, Syracuse, New York. Authorized allocations for 1985-86 found in FONAPAR Budget Plan, 1985-86/MOF.

of observations can be made about the changing composition of these distributions. First, the share of the national government entities markedly decreased between 1981 and 1984. Second, while the absolute amount of codified allocation to the provincial councils funds increased by 50 percent from 1984-85; its relative share of total FONAPAR funds decreased 6 percentage points. The major increases in FONAPAR distribution are to the municipalities--a whopping 200 percent from 1984-85, and the special authorization to Esmeraldas/Napo. The consequence of this changing composition of FONAPAR distribution is highlighted when examining the allocation and earmarking of FONAPAR funds.

Allocation Criteria of FONAPAR. The allocation criterion significantly differ between the municipal, provincial council and national entity distributions.⁵ The municipal allocation requires a balancing of economic and financial considerations; the provincial councils' 2 percent share distribution is allocated by a legislated formula; and the national government distribution covers specified fixed costs.

The municipal grants, "retencion automatica" and investment, are determined in an aggregate fashion (FONAPAR 1985-86 Budget, MOF). The 1985-86 plan adopted an additional criteria, that of population share. The four criterion used in the allocation of the 1985-86 plan are the following:

1. A hold-harmless policy using the previous year's level of FONAPAR funding as a benchmark. The foremost concern in

⁵Memorandum No. SP84-10196, Asunto: Proyecto de Presupuesto del FONAPAR, 1985-86.

allocating municipal funds is to at least provide as much this year as was distributed last year. Should a municipality receive more than the prior year's allocation, there is no adjustment mechanism in the following year's allocation. The increased amount becomes the new benchmark level.

2. The remaining funds are distributed based on an increase in the municipal's population share (using 1982 Census data) in comparison to the national level.
3. The economic and financial situation of the municipalities. Using information provided in the municipal budget plans approved by CONADE, FONAPAR reviews the types of municipal expenditures and current investment projects, the debt situation of the municipalities, and the revenue capacity of the municipality. It is at this stage that the expenditures are earmarked for the "retencion automatica" and investment. As required by law, only 50 percent of the "automatica" can be used for fiduciary payments (i.e., public debt, amortization and principal).
4. The availability of additional revenues at the time of disbursement. In the 1985-86 plan, it is acknowledged that the municipal allocation based on hold-harmless and population share may be "insufficient." Insufficiency implies the inability of the municipality with its FONAPAR support and local revenue capacity (or lack thereof) to finance their current and capital budgets. As a safety valve, the 1985-86 budget identifies S/.1,000 million which will be generated from import tariffs as possibly paying for these insufficiencies. Essentially, these monies become a deficit financing mechanism for the municipalities.

From the above discussion, one's first impression is the status quo nature of the allocation criterion. The hold-harmless policy essentially ensures no major complaints at the municipal level. The technical criterion of population share (which could be interpreted as a measure of need) only enters the formulation once the status quo has been ensured. The availability of additional revenues based on economic and financial situations probably encourages municipalities to abandon conservative

fiscal policy, and certainly does not encourage municipalities to develop their own revenue raising capacity. Also, these additional non-allocated revenues attract "politicking" congressional representatives, and undermine the established allocation process.

In justice to the current Administration, the population share weight is a first step in rationalizing the allocation process. Yet, only the surplus amount, over and above the hold-harmless distribution, was distributed under this criteria. To move toward rationalizing this program, would most probably force a conflict between the hold-harmless policy and the population share criterion.

Another critical issue is that of the use of FONAPAR funds to finance public debt (amortization and principal of local investment projects, or investment feasibility studies.) Given the recent increase in municipal debt, there should be considerable concern with the capacity of municipalities to repay debt. Municipal debt is largely a function of municipal investment. Syracuse University has found in select cities in Ecuador, most particularly Ambato, that municipal investment has increased dramatically as a percent of real spending, being at 44 percent in 1971 and at 60 percent in 1984. Certainly FONAPAR, a national program which funds municipal investment, may be sending the wrong message to the municipalities. That is, FONAPAR encourages and finances the undertaking of investment projects but provides neither for the operation of such projects nor aids in the development in the municipal capacity to operate and maintain such projects. This is an area of important research which would need to take into consideration the municipalities, the domestic and foreign lenders to municipalities as well as FONAPAR.

The provincial councils' receipt of the 2 percent central government budget is allocated by a legislated formula: 25 percent share to Quito, 25 percent share to Guayaquil; and the remaining 50 percent share distributed equally to the other 18 provincial councils. While this formula is clearly specified, one must question the underlying objectives of the formula. Certainly the formula distributes funds to Guayaquil as a per capita share, with the relative population share of Guayaquil at 26 percent (see Table 9). Yet extreme discrepancies emerge when comparing the population distribution e.g. Portarejo (10.3 percent of the nation) with that of Zamora (.6 percent). Equal share distribution clearly favors the smallest of areas, while a case can be made that because of limited economic bases, small areas have greater need, yet it is quite unlikely that equal amounts to all provincial councils presents an equitable distribution. However, the use of a formal distribution system reduces the potential for allocations governed by political favor.

The national government entities funds are allocated based on fixed cost submissions to FONAPAR. No allocation criterion other than precedent, is the rule. While these allocations have been decreasing in relative terms, and represent only 3 percent of the total 1985-86 distribution, the unspecified nature of the allocation opens the door for political maneuvering and payoff.

The special congressional allocations also represent political pulling, but on the congressional side. The Napo/Esmeraldas authorization in 1985-86 clearly challenges the rationalization of distributing municipal funds through FONAPAR. The allocation formula for the Napo/Esmeraldas

TABLE 9
 POPULATION SHARE AND PERCENT DISTRIBUTION OF THE
 2 PERCENT OF CENTRAL BUDGET ALLOCATION, BY
 PROVINCIAL COUNCILS, 1985

| <u>Provincial Capital/ Province</u> | <u>1985 Provincial Population Share</u> | <u>Legislated Share of 2 Percent Allocation</u> |
|---|---|---|
| Quito/Pichincha | 17.7 | 25.00 |
| Guayaquil/Guayas | 25.7 | 25.00 |
| Cuenca/Azuay | 5.4 | 2.77 |
| Guaranda/Bolivar | 1.7 | 2.77 |
| Azogues/Cañar | 2.2 | 2.77 |
| Tulcán/Carchi | 1.5 | 2.77 |
| Latacunga/Cotopaxi | 3.4 | 2.77 |
| Riobamba/Chimborazo | 3.9 | 2.77 |
| Ibarra/Imbabura | 3.0 | 2.77 |
| Lojo/Loja | 4.2 | 2.77 |
| Ambato/Tungurahua | 4.0 | 2.77 |
| Machala/El Oro | 4.2 | 2.77 |
| Esmeraldas/Esmeraldas | 3.1 | 2.77 |
| Babahoyo/Los Rios | 5.5 | 2.77 |
| Portoviejo/Manabi | 10.3 | 2.77 |
| Morona/Morona Santiago | .8 | 2.77 |
| Pastaza/Pastaza | .4 | 2.77 |
| Tena/Napo | 1.6 | 2.77 |
| Zamora/Zamora Chinchipe | .6 | 2.77 |
| San Cristóbal/Galapagos | .08 | 2.77 |

SOURCE: MOF, based on projected population as of December 31, 1985.

provinces is specified as: 25 percent/25 percent to the two provincial councils; the nine municipalities in Napo receive 2.7 percent share of total; and the five municipalities in Esmeraldas receive a 3.1 percent share of total. The ability of the Congress to establish an allocation formula for the authorization of public funds suggests a readiness to return municipal finance issues to congressional control. This issue should be carefully examined. These are a number of explanations for this special authorization. Given the importance of oil revenues to the fund, and the source of the revenues being in Napo/Esmeraldas, some feel that this special authorization is appropriate compensation. Others question the politics, as the special authorization was an executive rather than a congressional initiative.

Earmarking of Funds. FONAPAR exerts control over its spending program by earmarking funds to the municipalities.⁶ Two types of earmarking exist: unenforced earmarking, the "retencion automatica"; and enforced earmarking in the case of the investment cost-reimbursement schedules. In the case of the "retencion automatica," the budget plan prescribes the amount of the administrative and fiduciary costs which can be covered by the grant; yet in the case of the former, there are no reporting requirements to issue the funds. The funds are automatically issued on a monthly basis. The only requirement is an annual one, that the municipalities submit their annual budgets to CONADE for approval. Given this lack of accountability, this earmarking is unenforceable.

⁶The provincial councils, national government entities or special authorizations do not have earmarked expenditures.

The reporting requirements entailed in the investment grant program are extensive. Distribution of funds are made during the fiscal calendar year only upon submission of detailed costs and requested documentation for items approved in the budget plan. This enforced earmarking is a major impediment to the movement of FONAPAR funds. The disbursement delays due to paperwork, lack of communication and politicking are significant and will be the focus of the disbursement section.

A second aspect in the earmarking of FONAPAR relates to the ability to evaluate the effectiveness of the FONAPAR expenditure. The "retencion automatica" primarily supports municipal administrative expenditures, including staff salaries. At the provincial level, the "automatica" covers program administrative costs, but not the staff salaries. To evaluate the effectiveness of the funds, one would have to examine municipal management capability and expertise. Yet by the unenforced earmarking, FONAPAR has no control on how the municipalities use their "automatica"; thus the effectiveness of FONAPAR "automatica" is determined by the municipalities.

The enforced earmarking of the investment program gives greater accountability and control of funds to Budget/MOF. Yet the effectiveness of the FONAPAR investments is clouded by the fact that FONAPAR may only provide partial funding to many municipal investment projects. Traditionally, FONAPAR funds are available to finance start up costs for large investment projects and in many instances are used to retire investment loans. However project plans, designs, feasibility studies as well as loan conditions are not subject to FONAPAR review. Rather, these are the domain of other government institutions. With FONAPAR being only a

slice of the total pie, the evaluation of use of FONAPAR investment funds is intimately tied to the overall project, and therefore makes effective evaluation of the impact of FONAPAR extremely complicated. The lack of rigidity in the funding flows, be it FONAPAR, BEDE, INCEL, etc., inhibits accountability within the funding structure. We will see later in this report how CONADE is essential in evaluating these investment projects. For purposes of evaluating the administration of MOF/Budget, the effectiveness of FONAPAR is defined by the timeliness of FONAPAR funds. The following identifies the disbursement process and its major obstacles.

Disbursements of FONAPAR

The type of grant dictates the means of disbursement. Moreover, the timing of request for funds and the means of disbursement are closely tied issues. The "retencion automatica" of the municipalities, the 2 percent share to the provincial councils, and the national government entities receipt all are distributed automatically on a monthly basis by the Central Bank. Once the codified budget is signed by the Minister of Finance, the Central Bank's Disbursement Division receives instructions from the Budget/MOF to automatically issue these monies to the appropriate recipients. In the past, several MOF officials claim that the Central Bank did not issue these funds given the deficit condition of the FONAPAR account. In 1985 with a surplus account, the monthly automatic payments were on schedule for the fiscal year, as of May, 1985 (see the schedule of payments below).⁷

⁷Memorandum 6-85 por Victor Garcia Lomas, Asunto: transacciones de Caja.

FONAPAR DISTRIBUTION 1985
(in thousands of sucres)

| | <u>Initial Authorization</u> | <u>Codified Authorization</u> | <u>Effective 5-85</u> | <u>Percent</u> |
|------------------------------------|----------------------------------|-----------------------------------|---------------------------|----------------|
| Retencion Automatica Investment | S/.2,900,690 6,877,302 | S/. 3,609,725 8,136,275 | S/.1,504,052 1,922,791 | 41.6 23.6 |
| Total | S/.9,778,000 | S/.11,746,000 | S/.3,426,843 | 29.1 |

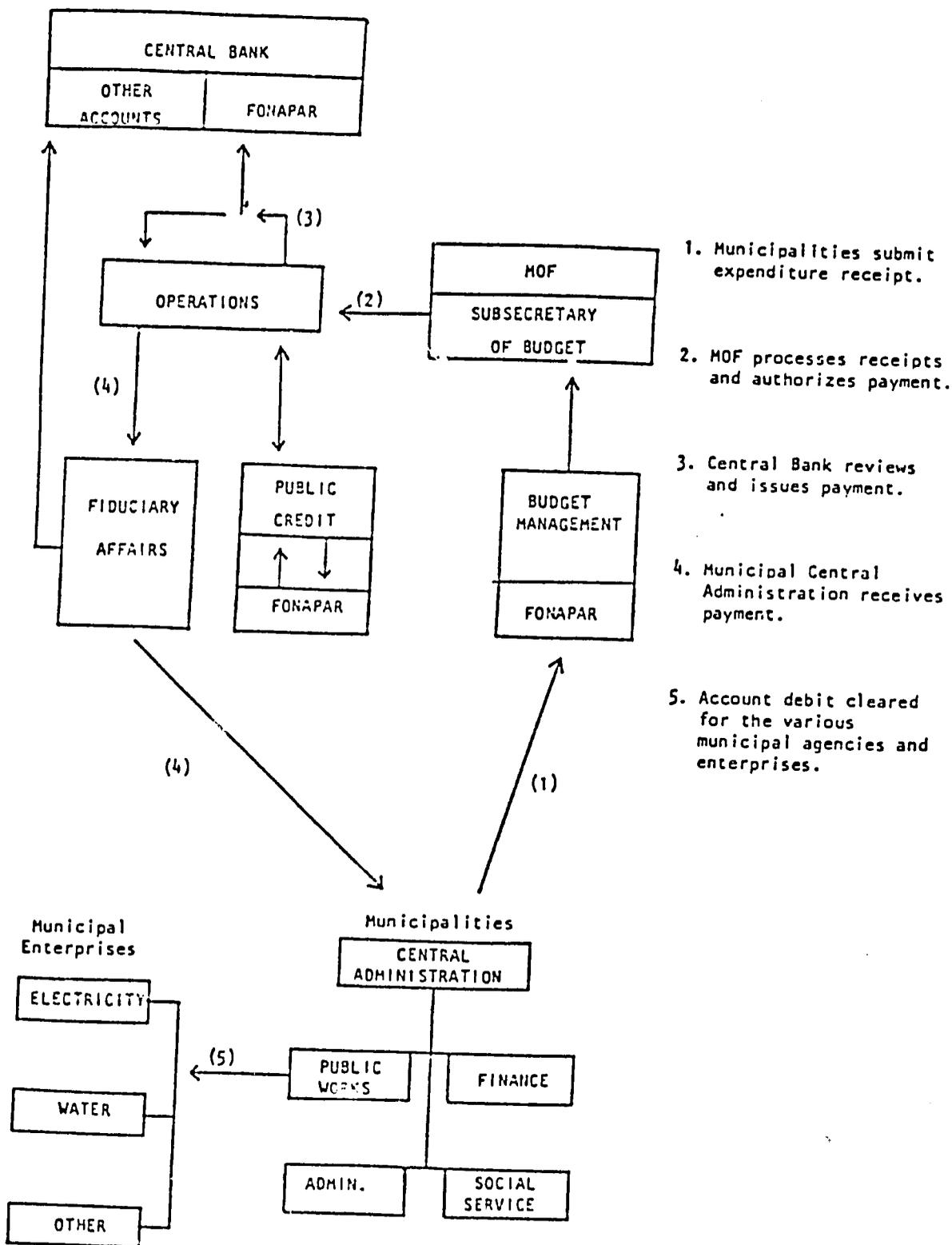
(Memorandum 6/85 por Victor Garcias Lemas. Asunto Transacciones de Caja de Fonapar.)

The problem in disbursement arises in the investment distribution which is a cost-reimbursement schedule. As of May, 1985 only 23.6 percent of funds had been distributed for the fiscal year. The most frequently stated explanation for these delays is the reporting requirements. Two types of documentation are required: 1) contractual documentation and appropriate Ministry/CONADE approval for project start-up costs; and 2) expenditure receipts for approved capital costs. All documentation is submitted to the Budget Management office within the MOF/Budget.

The Budget Management office reviews the submission, ensuring that the expenditure is allowable under the authorized budget and drafts a memorandum to the Central Bank for the issuance of the disbursement. Paperwork generated from this review is considerable and includes: a memorandum of explanation to the Subsecretariat, an Issuance Memorandum to the Central Bank, and Telegram Notification to the recipient. Approximately 130 individual disbursements are issued daily in the Budget Management office (see Figure 3).

The Central Bank receives the issuance instructions which are then processed by the Public Credit Division/FONAPAR representative at the

FIGURE 3
DISBURSEMENTS OF FONAPAR FUNDS



SOURCE: Based on conversations with MOF/Central Bank Officials; Ley de Regimen Municipal.

Central Bank. This office reviews the payment per their budget instructions, and then request for the transfer of these monies to the recipient. In cases of fiduciary commitment, the transfers are made from the FONAPAR account to the specified institutional account also located in the Central Bank. This fiduciary transfer can be part of either the "automatica" or the investment assignment. Except for the fiduciary committed payment, the municipalities receive the transfer revenue from the Central Bank. The central administration of the municipality is the recipient of FONAPAR funds and is responsible for distributing them to their assigned destinations, be it municipal agency or enterprise.

These reporting requirements are a major reason for delays in funds, yet they also are the only accountability measure within the FONAPAR program. The eight analysts within the Budget Management office are hounded with paperwork. While a computer is available to generate summary statistics, there is no computerization of the daily information management of this office. In 1984, summary data was entered into the computer by the Budget Management analysts, yet the lack of software made processing of the data take over a month. Certainly, if FONAPAR continues these reporting requirements, a rationalization and computerization of the current information system should be undertaken.

Two other factors are essential to explaining the disbursement delays: lack of communication between FONAPAR and the municipalities; and the politicking of national and local officials. The communication between FONAPAR and the municipalities occurs only when there is a problem with the receipt submission. FONAPAR has no provincial or municipal representatives working with local governments to resolve problems before they start.

As in all government spending programs, politics shadow government administration. FONAPAR is no exception. A quagmire created by the reporting requirements and lack of communication between FONAPAR and the municipalities is often resolved by "bending the rules" through political pressures. Given the reality of the politicking, it might be suggested if FONAPAR is to continue in its present form, that it institutionalize politics into the process through committee meetings, congressional forums and municipal conferences. This would at least give equal voice to all constituencies, and limit the number of closed-door sessions.

Institutional Relationships

In the introduction, the inter-institutional framework of FONAPAR was presented. The primary actors are the Ministry of Finance and its Budget Subsecretariat, the Central Bank, CONADE, the lending agencies, and the FONAPAR recipients; the municipalities, the provincial councils and the national government entities. The preceding discussion has emphasized the processes involved in the revenue determination, budget authorization, and disbursement request procedures of the FONAPAR program. All of these responsibilities fall under the Budget Division of the MOF. However, in performing these duties, the MOF officials work with other branches of the central and local governments. And since 70 percent of FONAPAR funds are earmarked to municipal investment, FONAPAR is intricately interwoven with municipal investment projects. Let us now explore these inter-institutional ties and their effect on the performance of FONAPAR.

FONAPAR and the MOF

An essential administrative feature of FONAPAR is the organization of the various MOF officials within the Budget Division/MOF who work on the

FONAPAR program (see Figure 4). Under the Ley Organica, the Budget Division is organized into specific functional offices (i.e., Program and Evaluation of Revenues, Budget management, etc.). Each of these offices is responsible for specific tasks in the administration of FONAPAR, yet no one program office exists to coordinate nor officially represent FONAPAR. Rather the Subsecretariat and his Deputy coordinate these tasks.

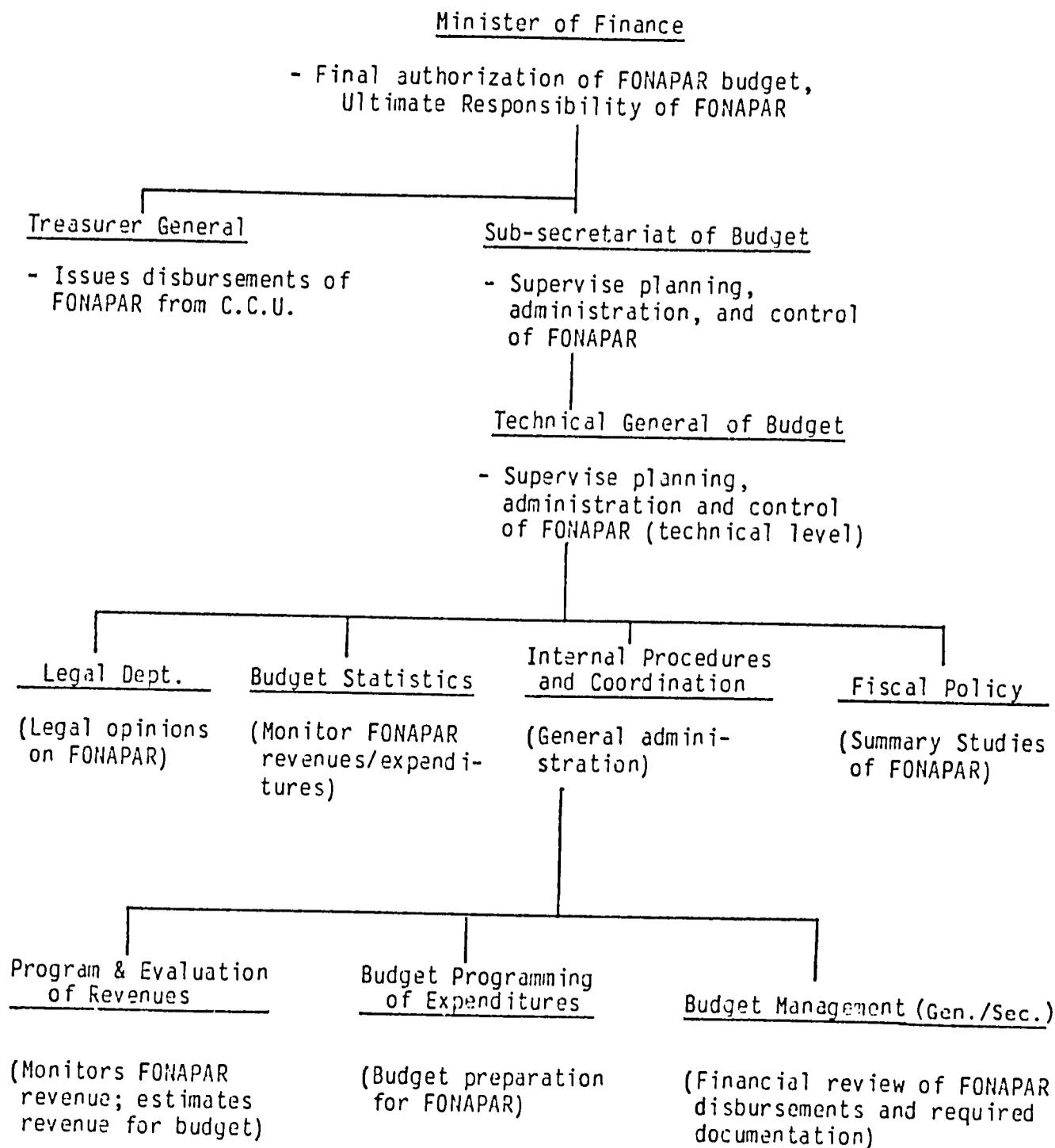
Moreover, each of the offices involved in FONAPAR have other responsibilities. It is estimated that 20 percent of each office's time is devoted to FONAPAR administration; 10 percent to FONEN and 70 percent to the central government budget. The exception to this staff allocation is within the Budget Management office where eight financial analysts work solely on FONAPAR administration, reviewing the documentation and issuing the disbursement requests.

The decentralized nature of FONAPAR administration emphasizes that FONAPAR is a "mover" of funds. It also must be noted that the decentralized system gives large power to the Subsecretariat, the only one person coordinating the whole program. A consequence of this decentralized structure is in the inconsistent communication of the Budget/MOF with other institutions regarding FONAPAR revenue, authorization, and disbursements. No one person, other than the Subsecretariat, represents FONAPAR to these different national and local organizations. This lack of official representation of FONAPAR may well undermine the institutional relationships necessary to make an effective FONAPAR program.

The Central Bank

As discussed in the previous sections, the Central Bank plays important roles in the revenue collection and reporting of FONAPAR funds,

FIGURE 4
OPERATION OF FONAPAR WITHIN MINISTRY OF FINANCE



SOURCE: Reglamento Orgánico Funcional de Sub-secretaria de Presupuesto Acuerdo Min. #14, 1935; and "Organama Estructura del Ministerio de Finanzas y Credito Publico", MOF.

as well as the disbursement of FONAPAR expenditures. The Central Bank, as the "keeper of the gate," represents the national fiscal interest: that of keeping the FONAPAR account out of deficit. Certainly, the lumpy flow of funds is a consideration in the disbursements of FONAPAR expenditures, and the Central Bank attempts to regularize the revenue-expenditure flows, at least on an annual basis. As reported by the MOF, the Central Bank reporting of FONAPAR revenues has been a source of confusion. Clarification of revenue reporting guidelines should be undertaken in conjunction with the MOF, Treasury and the Central Bank.

Additionally, the Central Bank is an enforcer of the expenditure earmarking. All FONAPAR disbursement requests from the Budget/MOF are reviewed by the Central Bank Disbursement Division. The second review of expenditure reimbursements duplicates the Budget/MOF review. Is a double review necessary? A Central Bank official points to past problems where MOF has issued requests for unapproved funds. On the other hand, MOF officials state the frustration of issuing FONAPAR requests which the Central Bank does not intend to honor. The most noticeable institutional gap is that there is no inter-institutional framework to handle these problem cases. In fact, once the MOF issues the request and telegrams the recipient, the MOF receives no notification from the Central Bank that the funds have been issued. The only response directed to the Budget/MOF is from the angered recipient who has not received his funds. This lack of coordination between the agencies of the national government is a serious problem, especially when considering the animosity which often exists between the municipal councils and the national government. Organizing

monthly review meetings between MOF and the Central Bank is critical to increasing communication and coordination between these two organizations.

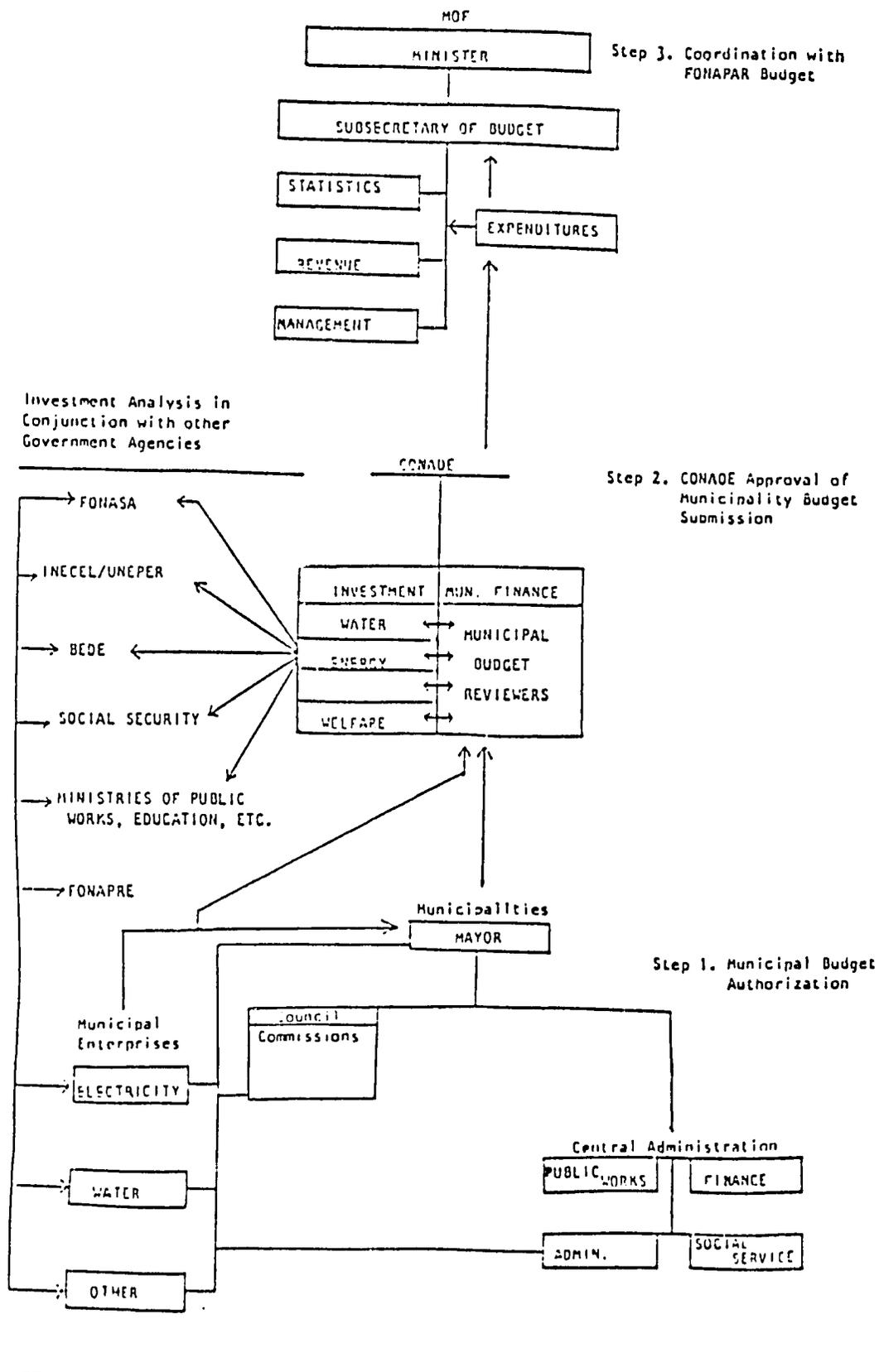
CONADE

CONADE is the national planning office of Ecuador. Its significance to FONAPAR is its relations to municipalities in the planning of municipal investment. CONADE is the primary spokesman for the municipalities at the national level. The overall coordination of municipal finance at the national government level is under the jurisdiction of CONADE. The task of CONADE is to balance the municipal budget request/authorization with the availability of central government funds and to ensure these investments support the National Plan of Ecuador.

As discussed in an earlier section, MOF/Budget drafts the FONAPAR budget in coordination with CONADE. The information required for earmarking funds to the "retencion automatica" and the investment projects in the FONAPAR budget is provided by the Municipal Finance section of CONADE (see Figure 5). The information represents the municipal budget request which is approved by CONADE. It must be emphasized that the MOF in the earmarking of FONAPAR funds is dependent on CONADE for this information. MOF receives no information from the individual municipal governments relating to their budget preparation.

MOF/Budget views CONADE under a limited perspective: CONADE is an information source in the planning of the FONAPAR budget. This view contrasts with the CONADE perspective: that FONAPAR is an integral part of municipal finance, yet it is only one source of municipal funding. Local revenues, loans from BEDE (the Ecuadorian Development Bank), loans and

FIGURE 5
MUNICIPAL BUDGET SUBMISSION/APPROVAL



SCURCE: Ley Regimen Municipal, July 1985; Interviews of MCF and CONADE officials.

grants from other private enterprises and governmental units (i.e., INECEL, Social Security) all represent sources of municipal funding. FONAPAR is a major source of funds for the essential administrative services, as well as for the fiduciary start-up costs of investment programs.

CONADE focuses on the integrated nature of FONAPAR and the other municipal funding sources. CONADE, in approving municipal budgets, places a stamp of national approval on the expenditures that are earmarked by FONAPAR. Moreover, in assessing these municipal budgets, CONADE evaluates the fiscal capabilities and requirements of the municipalities. Given this control of CONADE in the approval of municipal expenditure, one could view CONADE as the evaluator of the performance of FONAPAR investment. Let us now explore how CONADE evaluates municipal expenditures as part of its budget approval process.

Financial analysts in the CONADE Municipal Finance Section review the municipal budget requests. As one CONADE official states, the municipal request is a "wish list" with the requests almost doubling the availability of funds in some instances. In evaluating municipal requests for investment funds, CONADE analysts work with the representatives of the various funding agencies (i.e., CONADE, BEDE, Social Security, etc.). In the case of FONAPAR, CONADE officials work with the Office of Expenditure in Budget/MOF, as discussed in the following section.

In analyzing the municipal budgets, the Municipal Finance Section of CONADE coordinates with the Investment section of CONADE. The primary objective of the Investment Section is to ensure the implementation of the National Plan, the key document published by CONADE. The Investment

section is organized into four subgroups: water, energy, urban development and welfare projects. These subgroups are the major liaison between the other government agencies working with the municipalities.

As Figure 5 illustrates, working relationships exist between FONAPRE (investment feasibility studies), FONASA/IEOS (water projects), INECEL/UNEPER (road and transportation projects, BEDE (loan financing); Ministries of Public Works, Education, Health, etc. The subgroups of Investment/CONADE work with these various institutions. Ministerial approval of the project and financial commitment of the lending institution (in the case of BEDE) are required documentation by CONADE. Investment/CONADE reports their findings to the Municipal Finance Section/CONADE which in turn reviews the municipal budget request with this information. Should there be serious problems with the requests, CONADE can opt not to approve the request.

The CONADE approval process allows considerable influence of the national government over the spending of the municipalities. Additionally, the approval process is the primary mechanism to align national government spending programs, be it FONAPAR, BEDE or INECEL, with the objectives of the National Plan. This discussion points to the need for coordination between MOF and CONADE given the integrated aspects of budget planning, administration and evaluation. In the planning of the 1985-86 plan, MOF and CONADE worked closely and their coordination was impressive. Continuing this relationship should be encouraged with monthly meetings between the MOF disbursement analysts and CONADE officials. These meetings would identify projects which are not meeting the guidelines as established

by FONAPAR and CONADE, and consider alternative action to either enforce the guidelines or to amend them. Sharing the information would allow the national government to have a unified front to the municipalities, as well as to identify problems in the disbursement flow.

One final note related to the interaction between CONADE, the Central Bank and FONAPAR is that CONADE and the Central Bank are major contributors to the accountability of FONAPAR and the activities it supports. Reform of FONAPAR within the MOF would need to consider possible effects on the institutional control of these two other national institutions.

Other Lending Institutions

The investment expenditures of FONAPAR often are earmarked to the fiduciary or capital costs of large municipal investment projects. The lending institutions such as BEDE depend on the FONAPAR grants to municipalities as the funding used to repair their loans. There is no direct relationship between MOF/Budget and BEDE (or other lending institutions) in the administration of FONAPAR. Only through CONADE's review and approval of municipal expenditures are the fiduciary requirements of the lending institutions balanced with the availability of FONAPAR revenues. Should the fiduciary clause of the FONAPAR program be reduced, it would be of significant consequence to the lending institutions. This issue should be further evaluated with interviews of officials from BEDE, CONADE and other relevant agencies.

The Municipalities

The municipalities are the primary beneficiaries of the FONAPAR program. The municipal involvement in the administration of FONAPAR takes

place at two levels: 1) an indirect relationship in the budget authorization of FONAPAR; and 2) a direct relationship in the cost-reimbursement reporting and the disbursement of FONAPAR funds.

Budget Authorization. As described in the CONADE section, the municipalities are required to submit an annual budget to be approved by CONADE. It is this approved budget which provides the guideline for the earmarking of FONAPAR revenues. Let us first examine this municipal process (see Figure 5).

As specified in the Ley de Regimen Municipal, the various administrative agencies of the municipal government present their budget requests to the Director of Finance within the Municipal Central Administration. The Office of Finance in turn drafts a budget plan to be presented to the Municipal Council. The degree of complexity of the municipal budget process largely depends on the size of the municipality. As no mayor is elected in municipalities of under 50,000 inhabitants, the chairperson of the Municipal Council coordinates the budget preparation with the Director of Finance. For municipalities over 50,000 inhabitants, an elected mayor is responsible for the presentation of the central administration budget.

For these larger municipalities, the decision-making structure of the municipal budget process is composed of the municipal central administration, municipal enterprises if any and the municipal council. The central administration is under the arm of the mayor; the municipal budget in its entirety is submitted by the Mayor's office to the Council for approval. In contrast, the municipal enterprises directly present

their individual budgets to the Council for approval. These enterprises are authorized by the Council and report to the Council Commissions. Thus they are the most autonomous units not under the control of the Mayor's office (see Figure 5).

The municipal enterprises are the main administrative units in projects such as water, electricity and sanitation. Central administration primarily administer roads, parks and office/market projects. As sketched in Figure 5, municipal enterprises and the central municipal administration coordinate the planning of their investment projects with other central government agencies. The relationship with the central government agencies usually relates to the financing of the investment project and/or the technical specifications of the project.

While the investment costs of the municipal enterprises are included in the central administration's budget under its Public Works Division, the authority and control is largely in the hands of the municipal enterprises and municipal councils. Under the Ley de Regimen Municipal,⁸ the municipal budget authorization is to be completed by September of each fiscal year. The budget contains the central administration revenues and expenditures with appendices of all municipal enterprises.

As previously discussed, CONADE reviews and approves these budgets and it is these itemized expenditures which become the guide for FONAPAR earmarking. It must be emphasized that the municipalities have no direct relationship with MOF in the budget planning stage; their only interaction is with CONADE.

⁸Ley de Regimen Municipal, Ley del Impuesto a la Plusvalia, Julio 1985, Corporacion de Estudios y Publicaciones, Quito, Ecuador.

Disbursements of FONAPAR funds. In the disbursement process, the municipalities present their cost and document submissions to the Budget/MOF in order to be reimbursed for their expenditures. The municipal central government is responsible for these cost submissions. In examining the disbursement process, several FONAPAR and CONADE officials identified these municipal cost submissions as being the most serious obstacle in the movement of funds. There have been many reasons given: lack of technical personnel in the municipality; the regional animosity between Quito and the coast; and the presence of political pressure in the allocation. All of these aspects may influence an individual region and/or project. Especially the lack of qualified technical planners in the rural areas is a factor which all interviewed officials identified as relating to disbursement delays. Beyond this, there is reason to believe that there is a fundamental conflict in the organizational decision-making structure at the municipal level which undermines this disbursement process.

Let us return to the budget-making process at the municipal level. In smaller municipalities with no mayor nor municipal enterprises, the municipal council is the decision-making body for both budget and disbursements. However, in larger municipalities, there is a dual decision-making body of central administration (i.e., Mayor) and the municipal councils. The central administration budget is approved by the Council while each expenditure/disbursement is under the Mayor's office. Only the municipal enterprises report directly to the municipal council, and not through the central administration (Mayor) office. In the reporting of costs, the central administration submits all documentation to

the Budget/MOF. No municipal council approval is required. The central administration is mandated to execute the municipal budget, yet there is little control over the central administration in this implementation stage.

The dichotomy in the budget versus disbursement processes points to the underlying conflict in the municipal reporting of FONAPAR investment costs. As explained by one CONADE official, the central administration of the municipality, anxious to control investment decisions, redirects municipal spending to central administration categories, namely office, markets, parks and roads. Municipal enterprises, primarily under the control of the councils, usually are the losers in this disbursement stage. Thus, water and electricity projects are placed on the back burner. This might explain why such provinces as Esmeraldas still have serious problems in water supply, even though municipal water projects have been proposed for nearly twenty years.

Several CONADE officials alluded to this problem of budget authorization versus budget execution within the municipalities. On the other hand, MOF officials with little direct relationship with the municipal governments had no grasp of the municipal politicking which may be the underlying explanation for problems in the cost submissions of FONAPAR. The importance of this is its probable impact on all aspects of municipal finance, be it for BEDE, FONASA or other national government entities. Additional research on this topic is needed and should include: site visits to select municipalities, budget analysis of authorized versus actual budgets, and assessment of national initiatives to eliminate the municipal politicking of investment funds.

To conclude this section, the inter-institutional perspective is essential in the understanding of the FONAPAR program. The Central Bank and CONADE add considerable accountability into the FONAPAR program. The Central Bank is the comptroller of the funds; CONADE is the evaluator of the quality of the FONAPAR earmarking. Under the current division of tasks, the Budget/MOF is totally dependent on these agencies in the performance of their duties. Accompanying this dependency is the lack of understanding of the Budget/MOF regarding the influence of municipalities on FONAPAR.

Conclusions

Based on the findings of the above discussion, a number of conclusions can be draw. Moreover, these conclusions point to the major policy and research considerations open to the MOF and the national government relating to FONAPAR. This section will first summarize the report's findings; and secondly, present the policy conclusions and additional research needed to improve the workings of FONAPAR, and to clarify the policy options available to the government.

Summary of Findings

As the report was organized by revenues, expenditures and institutional relationships, so can the findings be organized in like fashion.

Revenues

- a. The phenomenal growth of FONAPAR primarily is due to the increase in the internal tax contribution, and most particularly, that of the petroleum tax revenue. Petroleum tax revenue represents 34 percent of the total FONAPAR base (1984).

- b. The internal taxes, particularly that of petroleum tax revenue and general income tax revenue, experience the widest fluctuations in monthly flow into the FONAPAR account.
- c. The monthly financial status of the FONAPAR account is most variable. Monthly balances in 1984 ranged from a deficit of S/.440 million in August to a surplus of S/.390 million in October.
- d. Disbursements of FONAPAR funds are lagged to the flow of revenues into the fund. In 1984, 60 percent of FONAPAR funds were distributed in August-December; during this same period, 40 percent of annual revenue flowed into the account.
- e. The reporting and projection of FONAPAR revenue is the responsibility of the Central Bank. The Budget/MOF is dependent on the Central Bank for these revenue projections.
- f. The lottery and shared sales tax on cigarettes represent only 9 percent of total revenues in 1984. No local tax revenue contributes to FONAPAR.

Expenditures

- a. The dramatic growth in FONAPAR revenues increasingly has supported municipal investment expenditures. As of 1985, over 70 percent of all FONAPAR was directed to municipal investment projects. Moreover, this figure may be higher given that the "retencion automatica" (monthly automatic payment) covers public debt and fiduciary costs, costs related to municipal investment.
- b. A two year expenditure plan (budget) is drafted by Budget/MOF and signed by the Minister of Finance. The plan includes: 1) two year revenue projections, 2) obligating and earmarking of specific expenditures for Year 1; and 3) obligation with only general earmarking of expenditures for Year 2. While amendments can be issued to this budget, there is no institutionalized process to amend the budget.
- c. The allocation criterion for the FONAPAR budget varies depending on the type of grant. In the case of the municipalities (which represents approximately 70 percent of FONAPAR funds), there is no technical nor specific formula. Rather, a hold-harmless policy based on the past

year's level of FONAPAR funding is used as a benchmark. Most recently, increases over this hold-harmless policy are based on increases in population share. As legislated, no more than 50 percent of FONAPAR funds are to cover fiduciary costs.

- d. Earmarking of revenues to specific expenditure categories is done in the municipal budget plan of FONAPAR. Earmarking is unenforced (no reporting of costs for disbursements) in the case of the "retencion automatica," and is enforced (cost-reimbursement submissions required) in the investment grant program. Earmarking enables the Budget/MOF to force the municipalities to comply with the requirement that only 50 percent of FONAPAR funds go to fiduciary costs.
- e. The cost-reimbursement investment grant is the primary mechanism of MOF to monitor and control spending in the municipalities. However, these reporting requirements also delay the disbursements of investment funds in FONAPAR. From January-May, 1985 only 24 percent of fiscal year funds in investment had been distributed. This compares to 41.8 percent of the funds for the "retencion automatica" being distributed during this same time period.
- f. The delays in disbursement due to cost submissions are aggravated by the lack of communication between the municipalities and the Budget/MOF. The confusion relating to the cost submissions opens the door for "politicking," political pressuring within the MOF.

Institutional Relationships

- a. The decentralized structure of the administration of FONAPAR within the Budget/MOF discourages consistent communication between the Budget/MOF and other government agencies. There is a lack of formal representation of FONAPAR with no one office within the Budget/MOF responsible for all its activities.
- b. The Central Bank is the "keeper of the gate." All FONAPAR revenues flow into Central Bank accounts, and their revenue is reported by the Central Bank. Additionally, all disbursements of FONAPAR are reviewed and issued by the Central Bank. Thus, the Central Bank is the caretaker of the fiscal health of the FONAPAR account. The Disbursement Division of the Central Bank duplicates the review performed by the Budget/MOF in ensuring that the costs submissions have been approved in the FONAPAR budget

plan. The Budget/MOF receives no confirmation from the Central Bank that its request for disbursement has been completed.

- c. CONADE, through its approval of municipal budgets, places a stamp of approval on the earmarked expenditures of FONAPAR. In the budgeting process, the Budget/MOF depends entirely on the approved municipal budgets of CONADE to earmark expenditures. The CONADE approval process ensures that these municipal investments support the objectives of the National Plan.
- d. Municipalities receive the largest chunk of FONAPAR funds. If the municipality is over 50,000 inhabitants, the budgeting of FONAPAR funds requires the approval of the municipal council and the mayor. This contrasts with the municipal cost-submissions to FONAPAR which is solely under the responsibility of the Mayor's office. One hypothesis of this report is that the dual decision-making structure within the larger municipalities creates conflict in the cost submission phase of FONAPAR. It is these cost-submissions which have been identified by Budget/MOF officials as posing the greatest difficulties in the movement of FONAPAR funds.

Policy Conclusions and Additional Research

The flow of FONAPAR revenues is most precarious, depending essentially on world oil prices. Disbursements are tied to this lumpy flow of revenue; and should this revenue flow decline, so would disbursements, given the Central Bank's independent position in disbursing of FONAPAR funds. This situation reflects Ecuadorian development in a microcosm. Oil revenues have been Ecuador's financial mechanism to development. The problem is how to introduce a transition to sources of income other than petroleum-related revenues. Certainly, developing a local fiscal capacity is an important component of eliminating FONAPAR's dependency on petroleum revenues. In turn, a local fiscal initiative should tap into the economic growth generated by the FONAPAR investment projects, thus linking the revenue and expenditure components of the program.

The route to reform of the municipal fiscal system is a most delicate question. To investigate the feasibility of such reform, Syracuse University is now examining the revenue capacity of the municipalities and provinces. Yet such an issue only begs another question: is the municipality an effective mechanism of local tax administration in Ecuador? The historical autonomy of the municipalities suggests that the administration of a shared tax system with the national government would be extremely difficult. The autonomy of the municipalities is witnessed in the FONAPAR program with the political agendas of the municipalities undermining the cost submission requirements of FONAPAR. These political forces may well surface in any local tax initiative mandated at the national level. Additional research on FONAPAR and the municipalities (see below) would reveal the importance of municipal influences.

As proposed in an earlier section, the dual decision-making structure of larger municipalities may encourage problems in the cost submission requirements. For municipalities over 50,000 inhabitants, the budget process requires approval of both the municipal council and the mayor; in contrast the cost submission requests for disbursement of FONAPAR investment funds is under the jurisdiction of the Mayor's office. Speculation has arisen that the Mayor's office submits cost reimbursement for expenditures which are politically advantageous for the Mayor, and not according to the approved budget plan. The underlying question is if the Mayor's

office is implementing the budget according to its legislated mandate.

To evaluate this question, additional research would include: 1) site visits to select municipalities to interview municipal officials; 2) analysis of actual versus authorized budgets; 3) joint meetings with CONADE and other agencies to discuss the impact of municipal submissions on national grant and lending programs; 4) identifying national initiatives (i.e., allocation and earmarking formula) which would limit the influence of such municipal political pressures.

The information requirements, be it those of the Budget/MOF, the Central Bank, or CONADE, all represent national control over the FONAPAR program. Several findings point to the need for greater communication between various institutions involved in FONAPAR.

Within the MOF

- a. The paperwork burden of the reporting requirements has increased substantially with the increase in the investment grant program of FONAPAR. Computerization of daily management tasks would considerably reduce these paperwork demands. Moreover, the computerization of FONAPAR accounts would allow for the Statistics Office of Budget/MOF to monitor requests made to the Central Bank to the funds actually distributed by the Central Bank. This coordination within the Budget/MOF would enable greater independence of the MOF in the administration of FONAPAR.
- b. The Revenue Service of the MOF and the Budget/MOF should coordinate information on revenues collected and compare their information with that generated by the Central Bank. The intra-institutional coordination would encourage greater autonomy of the MOF in the administration of FONAPAR.

MOF and Other Agencies

- c. MOF and the Central Bank should coordinate their information on revenue collection and effective

disbursements. As stated in an earlier section, there has been confusion in the past on the reporting of revenues to the Treasury which may lead to disbursement delays. Further research with Treasury, Budget/MOF, and the Central Bank should be undertaken to clarify and streamline the current reporting structure.

A second area of concern is in the cost-reimbursement/disbursement stage of FONAPAR. Both the Budget/MOF and the Central Bank review cost-reimbursement submissions to assure that these expenditures have budget approval. No formal mechanism exists to reconcile differences between the two agencies. In fact, there is no formal notification by the Central Bank to the status of the Budget/MOF disbursement requests. There is considerable need to coordinate between the two agencies. Through regular meetings and daily notification, the Budget/MOF and the Central Bank Disbursement Division could encourage movement of FONAPAR funds, eliminating the delays due to duplicative functions.

- d. CONADE and the Budget/MOF coordinated information in the drafting of the 1985-86 FONAPAR budget. This coordination should continue. Additionally, greater coordination between the Budget Management office of Budget/MOF and CONADE may resolve conflicts arising in the cost submissions of municipalities. One institutional alternative would be to establish an appeals board representing the interests of all three agencies (MOF, CONADE and the Central Bank) to resolve conflicts relating to the cost submissions of FONAPAR. The feasibility of such a Board of Appeals should be investigated by interviewing the appropriate offices in Budget/MOF, CONADE and the Central Bank.

One consequence of an Appeals Board would be to institutionalize the political representational aspects of the program. As of this writing, no open forum exists for exchange or discussion regarding the FONAPAR program. As suggested in an earlier section, the institutionalizing of politics into the system through committee meetings, appeal boards, Congressional forums and municipal conferences would give equal voice to all constituencies. Additionally, these sessions would clarify misunderstandings which emerge between the national agencies, the congress and the municipalities.

Underlying this process is the fundamental question related to the legal jurisdiction of municipal investment projects. Since its resumption in 1979, Congress has attempted to exert control over municipal investment projects. The Napo/Esmeraldas special authorization reflects this initiative. It is reasonable to predict that Congress will put increasing pressure on the executive branch to return municipal finance projects to congressional control. There are a number of serious considerations before adopting such a policy: 1) identifying the political and economic forces influencing the legislated special authorizations; 2) sequencing reform efforts by degree of political institutionalization; 3) assessing the consolidation of FONAPAR into the central government budget; 4) evaluating the consequences of such a reform, such as the impact on the type and amount of municipal expenditures, the ability of national agencies to meet the objectives of the national plan and the increased debt burden of the municipalities.

Another important policy finding is that the criteria of allocating FONAPAR to the municipalities lacks technical specification. Under the current policy of hold-harmless, the status-quo is maintained. The population criteria, an indicator of per capita need, only applies to the increase of revenue, over and above the hold-harmless criteria. Moreover, there is acknowledgement within FONAPAR that their "retencion automatica" should at least cover the administrative costs of the municipalities. Regretfully, there has been little concern with the relation between FONAPAR grants and the ability of municipalities to raise revenues.

The benefit of the current system is the fiscal stability it offers to the municipalities. Prior to 1971 when Congress authorized municipal expenditures, there was erratic flow of national revenues to municipalities. Yet, the current system is expenditure-driven; there is an inherent bias in the system for the municipalities to spend more, since their allocation depends on their expenditure level. Additional research is needed on the trade-off between the hold-harmless benchmark and the population criteria, alternative allocation formulas which would induce municipalities to reduce their expenditures and/or increase their revenues, and targeting of local fiscal initiatives to municipal expenditures categories.

Earmarking of FONAPAR funds and the cost-reimbursement reporting schedule for FONAPAR investment disbursements are the primary mechanism of national control over municipal spending of FONAPAR funds. These control mechanisms, however, lead to disbursement delays. Changes in the information flows as proposed earlier in this conclusion section might improve communication between the various participants in the reporting stage, and lead to less delay in disbursements.

Another consideration is eliminating the earmarking and reporting requirements altogether. For example, the allocation criteria would not earmark, nor would investment grants be issued by a cost-reimbursement schedule. In formulating a new allocation/disbursement policy, FONAPAR would need to examine the research topics discussed in the above conclusions, such as fiscal capacity of municipalities, political undermining of national initiatives at the municipal level, the stability

of municipal financial flows, the extent of national control to administer the National Plan, and the level and capacity of municipalities to service their debt.

One subject not included in the main body of this report is the lack of technical expertise of the municipalities in administering the FONAPAR program. It is generally acknowledged that the skill level of municipal employees is low, and is a fundamental reason for the delays in the cost submissions to FONAPAR. Development of the technical and administrative capacity of the municipalities is a task which has not been given sufficient consideration and effort.

CONADE representatives have shown a solid interest in exploring ways to improve both the technical capacity of municipal planners as well as the overall relationship between municipalities and the national government. This is a path which should be explored.