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ECUADOR MICRO-ENTERPRISE SECTOR ASSESSMENT: Policy Framework

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GEMINI

GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS

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Policy Framework

by

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PREFACE

This study of Policy Framework Analysis is one of four background studies sponsored by USAID/Ecuador as part of an overall assessment of the micro- and small-scale enterprise (MSE) sector in Ecuador. The ovarall purpose of the sector assessment has been to present a broad description of the nature and characteristics of the MSE sector as a basis for planning and designing future program interventions. Within this context, the Policy Framework Analysis was intended to identify key policy, regulatory and program constraints to MSE growth and development, and recommend specific reforms or improvements that would reduce impediments to entrepreneurial activities and success. In specific, the Policy Framework Analysis was to:

- Measure the extent to which direct regulatory controls, municipal laws and regulations, zoning, licensing, and registration affect the cost and effort involved in setting up and operating a small enterprise, dampen entrepreneurial drive, produce a misallocation of resources, penalize small entrepreneurs, and keep them in the informal sector;

- Analyze the impact of current interest rate policies, credit allocation through specialized lines of credit, effective rates of interest, and banking regulations on MSEs, and determine the effect of specific potential policy changes or reforms on the flow of credit to MSEs, and on MSE access to formal credit sources;

- Evaluate how present trade tariffs, the system of allocation of import permits, foreign exchange practices, and contraband or import activities affect small enterprises, and determine the effect of potential policy changes or reforms on MSEs;

- Assess the impact of tax and fiscal incentives on MSEs, and determine the effect of potential policy changes and reforms on MSEs; and

- Assess the impact of legislation and regulation covering wages, fringe benefits, severance pay, union activities and industrial regulations and working conditions on MSEs, and determine the effect of potential policy changes and reforms on MSEs.

The study team was composed of the following individuals:

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The team was assisted by Paulina Garzón, Cecilia Vásquez, and Eliana Pozo of the staff of the Instituto de Investigaciones Socio-Económicas y Tecnológicas (INSOTEC), an Ecuadorean nongovernmental organization that provided personnel and administrative support to the project team.

Field research for the study was carried out between August 12 and September 8, 1990.

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The team wishes to express its appreciation to the staff and officers of USAID/Ecuador for their insightful and helpful comments, critiques, and suggestions that were offered in numerous review sessions and early drafts of the report. In particular, we are indebted to Charles Costello, Mission Director; Robert Kramer, Deputy Mission Director; Derek Singer, General Development Officer; Mike Deal, Projects Officer; Maruska de Burbano, Enterprise Development Specialist; and Carmen Lopez, Project Assistant.

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We are also grateful for the time and patience of those involved in micro- and small-scale enterprise development in Ecuador who collaborated in the study. We wish to thank each and every one for the open and frank interviews, helpful suggestions and valuable insights into the fascinating world of micro- and small-scale businesses in Ecuador. Most important, we want to thank the entrepreneurs who shared their time and experience.

As in every study of this nature, however, the opinions, conclusions and recommendations presented in this report are the sole responsibility of the authors, and should not be interpreted as representing the opinions or official positions of any of the institutions or individuals who have so graciously helped in this effort.

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EXECUTIVE SUMMARY

Ecuador has moved away from a development strategy featuring import-substituting industrialization and toward a more open economy. A new concentration on economic policy dealing with micro- and small-scale enterprises (MSEs) merits attention in this new environment. They are privately owned, respond quickly to economic incentives, provide decentralized employment, and do not rely on government transfer payments for income growth.

Ecuador has stated goals of more investment, faster growth, and lower inflation. In the economic crisis of the 1980s, these goals proved elusive. Policies were motivated more by short-term considerations than by their long-term consequences.

In the area of financial and credit policies, the inflation rate has decreased since the end of 1988, but remains greater than 50 percent per year. At the same time, real bank credit outstanding has fallen to less than half its 1984 level, measured in real terms. At least part of this decline has been concentrated in a shrinkage of credit extended by the Central Bank of Ecuador (Banco Central de Ecuador [BCE]), while the shares of the Banco Nacional de Fomento (National Development Bank [BNF]) and private banks are higher.

At the same time that the real amount of credit declined and inflation continued, real interest rates were negative. Thus there was strong excess demand for loanable funds. Their allocation was not always based on the efficiency of the underlying investment projects. The rate of economic growth suffered accordingly.

Inflationary expectations were reinforced, making the process of inflation harder to arrest. Savings declined and investment sought inflation havens, including capital flight, rather than productive domestic uses.

A wide variety of agencies extend credit to Ecuadorian MSEs. The most prominent are Fondos Financieros and the Fondo de la Pequeña Industria y Artesania (FOPINAR). Their funding, both from international agencies and domestic sources, has been irregular. At the end of 1988, their loan volume in real terms had fallen to 44 percent of its level in 1981. Recent negotiations with the World Bank and the Inter-American Development Bank (IDB) have resulted in substantial new sources of funds.

Informal credit markets at high interest rates are also significant credit sources for MSEs.

Credit policy recommendations deal with the inflation rate, real interest rates on loans to MSEs, information and search costs for would-be borrowers, legally required loans to MSEs by commercial banks, and the role of participants in the development policy dialogue.

Labor policy centers on the Labor Code, originally passed in 1938. Its requirements for the payment of extensive fringe benefits and its job-security provisions (*establidad laboral*) raise labor costs for firms large enough to be visible.

Small firms ignore the Code, but their growth is inhibited by it. Were they to grow, they would be required to observe its provisions. Newly hired workers in growing MSEs as well as previous employees would be affected. The incremental costs of growth are thus higher for small firms than for larger ones.

At least two possible alternatives to the present situation exist. The report recommends consideration of a national unemployment insurance plan to replace the severance payments required by the Labor Code. In addition, the possibility of temporary exemption from payments of required fringe benefits is explored. The exemption would be available only to MSEs that become formally constituted, and would be strictly limited in duration.

With respect to trade policy, the decline of the strategy of import-substituting industrialization has led to a decline in the economic protection of some large firms, but it has not entirely removed the disadvantages at which small firms operate. For example, in principle, the lower of the dual exchange rates (the controlled rate) favors importers. But small firms cannot afford the red tape associated with registration, or the expensive (interest-free) advance deposits required. Accordingly, their imported inputs are purchased at the higher free rate. Because the inputs of small firms cost more than the inputs of large ones, the small firms operate at a competitive disadvantage under these policies.

The exchange rate has followed a pattern of mini-devaluations. In principle, the devaluations follow the domestic rate of inflation, but in practice they have not reliably kept up with it. Thus the sucre tends to over-valuation, lowering the profitability of firms, large or small, operating in the export sector.

CHAPTER ONE

INTRODUCTION

Small businesses are resolutely vigorous in rich and poor countries all over the world. It is no surprise that national economic policies inevitably affect their operations. This chapter explores the background behind these policies in Ecuador. The roots of specific policy concerns in the areas of financial, labor, and international trade policies are covered in detail in Chapters Two, Three, and Four.

In Ecuador, as elsewhere, all three sets of policies (financial, labor, and international) operate in a common national economic and political environment. Companies large and small follow regulations that govern credit, employment, exports, and imports. All are affected by prevailing interest rates, wage scales, and foreign exchange regimes. And all must try to convince political authorities to make decisions favorable to them. Although the three areas are treated independently below, they are separated only for purposes of exposition. At base, influences that affect one affect the others as well.

TRADE POLICIES

The biggest change in the Ecuadorian policy environment has come with the essential abandonment of policies based on the ideology of import-substituting industrialization. It is hard to exaggerate the importance of the change. The original arguments for industrial protection are nearly as old as industrialism itself. Alexander Hamilton advocated international protection and domestic industrialization for the newly independent United States. Friedrich List echoed the same themes at the end of the 19th century for Bismarck's unified Germany.

In Latin America, however, the most widely cited statement of the doctrine came first in 1949 in a publication of the U.N.'s Economic Commission for Latin America (ECLA) written by the Argentine central banker Raúl Prebisch.[1] As a proposal for organizing economic development in the second half of the 20th century, import substituting industrialization claims proudly its Latin American origins. It subsequently found favor in post-colonial, low-income countries all over the world.

Import substituting industrialization promised to lead its adherents to modernization and economic independence. It would simultaneously raise incomes and confront nagging pressures on the balance of payments. Payments problems arose when Northern demands for Latin America's exports of unprocessed

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[1]Raúl Prebisch, *Towards a Dynamic Development Policy for Latin America*. See also Prebisch, "Five Stages in My Thinking on Development," in Gerald M. Meier and Dudley Seers, *Pioneers in Development*, pp. 175-1917, with comments by Albert Fishlow and Jagdish N. Bhagwati.

agricultural and mineral commodities grew only slowly, while Latin America's demands for imports from the North rose faster.[2] An imbalance of international trade followed automatically.

Unequal growth in North and South, according to the model, forced the South to offer its goods at low prices in a competitive struggle, while allowing Northern producers and their workers to benefit from higher, oligopolistic prices. The trade imbalances mentioned above were thus reinforced by declines in the terms of trade for Latin American countries.

The solution for Ecuador seemed clear in a post-war period when wartime shortages had already stimulated the beginnings of Latin American industrialization. As Northern countries converted to civilian production, the infant industries of the South were to be protected until they achieved economies of mass production. The movement away from traditional activities in plantations and mines and toward modern industry was justified by the economic reasoning already mentioned. Ecuador joined enthusiastically in adopting this native Latin American model.

Only the effects of the international debt crisis of the 1980s led to a reexamination of these concepts in Ecuador. It became abundantly clear that, while infant industry had survived, its proposed benefits had not been realized. Shielded from competition, its costs and prices had risen rather than fallen. Its demands for foreign exchange to pay for imported inputs consumed fully two-thirds of export revenues. Its generation of productive employment was disappointing. In short, import substituting industries had become a burden on the rest of the economy.

The trade liberalization now occurring in Ecuador follows similar moves elsewhere, most notably in Chile. Mexico is moving in a similar direction, while reforms have also been made in Bolivia, Brazil, and Argentina. Each of these countries finds itself at a different stage in the process of liberalization, and the results have been far from uniform.

Trade liberalization is not without resistance. The decades of protection in Ecuador created strong vested interests, and these interests have sought to maintain their position through political maneuvering. It is not surprising that they should do so. Nevertheless, as Chapter Four makes clear, the movement toward freer trade is now well established.

While import-substituting industrialization dominated policy decisions, Ecuadorian micro- and small-scale enterprises (MSEs) suffered. Although numerous, they existed only on the fringes of a subsidized and protected sector in which they were not active participants. While trade liberalization will be favorable for MSEs, it will not be achieved overnight.

[2]Economists trace these differences to the differential income elasticities of demand for exports from the two regions, based in turn on the differences in their composition.

FINANCIAL POLICIES

Ecuador also shares a second background feature with other Latin American economies. A high rate of inflation (more than 20 percent per year) has now endured in Ecuador for a decade. Ecuador, of course, is far from Latin America's inflation champion. But in following a Latin American pattern, it shows common features with other low-income countries there.

Inflation's longevity, in Ecuador as elsewhere, creates expectations of still more inflation. It changes savings and investment patterns, and leads to a focus on unproductive real assets (for example, land, luxury apartments, jewelry) rather than productive real and financial assets.

An inflation of this magnitude may accompany high public-sector deficits, but in the end only monetary expansion can keep it going. If the money stock didn't increase, high public sector deficits would necessarily be offset by high private-sector surpluses. No inflationary excess demand would be generated by that combination.

However, a crucial difference separates most high-income countries from their poorer counterparts. In most high-income Northern countries, central banks and legislatures are independent. Monetary policy there is independent of fiscal policy.

The same is not true for countries where long-lived monetary expansion accompanies equally persistent inflation. Only by continued monetization of the public debt (that is, by the central bank creating new money to buy the IOUs issued by the treasury) is the deficit financed. No private-sector surplus is present. Increased public sector spending competes with continued spending by the private sector. Unless supply increases at the same rate, inflation is the predictable result. This process characterizes much of the observed high rates of Latin American inflation. The ways in which Ecuador has deviated from this pattern is spelled out in Chapter Two below.

The Ecuadorian inflation and its problems with the balance of payments feed on one another. If exchange rate devaluation lags behind the inflation rate, an over-valued local currency will discourage exports at the same time that it makes imports attractive. If exchange rate devaluation matches or exceeds the inflation rate, it leads to higher costs for all products and services in proportion to their import content, and thus helps maintain inflationary pressures.

Interest rates (the price of capital) are also affected by inflation. If market forces are permitted to set interest rates, a high inflation leads to high nominal rates. High nominal rates are always resisted by borrowers. A government seeking to spur investment, capital formation, and growth in output may try to do so by controlling the interest rate.

A lower-than-market interest rate, however, means that loans will not be optimally productive. When interest rates are low, the demand for loans exceeds their supply. Limited loanable funds are rationed. The ultimate allocation of these scarce loans follows criteria other than investment productivity. Political and social criteria are substituted.

If the amounts of economic sacrifice are carefully measured and well understood, the substitution of noneconomic for economic criteria is tolerable in the extension of credit. But in Ecuador, as elsewhere, these direct comparisons have not been made. Therefore, the economic costs of transfer payments for social purposes, in terms of sacrificed growth, cannot have been the object of systematic political attention.

LABOR POLICIES

In labor policy too, Ecuador is undergoing changes of surprising magnitude. Details appear in Chapter Three. Enacted in 1938, Ecuador's Labor Code embodied a set of advanced social welfare measures. It saw workers as inherently disadvantaged in the labor market, and took concrete steps to protect them from monopsonistic employers and capricious managerial practices. One of the most advanced in the hemisphere, the Code as amended is now one of the most expensive. Insipid growth of employment combining high productivity and high wages in formally constituted firms can be attributed in part to the Labor Code.

Small firms successfully evade labor regulations. They are informal and invisible. Tacit approval of that evasion is present even in the Ecuadorian agencies dedicated to the promotion of MSEs. When firms grow, they become visible. A growth into "formality" has some advantages for small efficient firms, but it also exposes them to the rigors of the costly labor code — not only for their new employees but for all those already on the payroll. In this way, the Code continues to discourage small firms' growth in employment, and encourages a continuation of the status quo.

Ironically these results are the opposite of those intended by the policies of import-substituting industrialization. The latter sought capital-intensive, high-productivity, high-wage industrial activities. The Code inadvertently induces firms to be so small as to be invisible and favors firms that use plenty of unskilled, low-productivity, low-wage labor. Typically these firms predominate not in advanced manufacturing but rather in artisan activities and commerce.

The outcome of this perverse set of incentives has been strengthened by the nature of Ecuadorian labor unions. Again, they mirror features also present in their Latin American counterparts. They are "political" unions rather than "business" unions, to use the economist's jargon. That is, they concentrate on winning benefits in the political arena rather than by through direct collective bargaining with employers. One interpretation views the Labor Code as the tangible result of unions' emphasis on political "conquests."

These processes have created a group of employees privileged because they have job security and income security, but at levels of income that are low by international standards. For example, much is made of size of the Ecuadorian public sector, all of whom are unionized and all of whom are protected by the Labor Code. But given the constraints on government spending during the debt crisis of the 1980s, the only way to have a big public sector is to pay low wages to most of its employees. Political rewards may inhere to such practices; political patronage is a characteristic feature of many young democracies.

ROLE OF SMALL BUSINESS

All three policy areas (trade, financial, and labor) in Ecuador affect the prospects for growth of MSEs. In the past, small businesses were neglected by policy makers. If big business prospered, the benefits would trickle down to other parts of the economy. Tax collections would finance transfer payments to the truly needy. All this assumed a degree of social consensus — a "social contract" — and a degree of efficiency in public administration that were simply absent.

Accordingly, Ecuadorians have re-examined the potentials of small business for employment and income. In principle, healthy small businesses can be productive, owing to an absence of managerial and other overheads. A strong set of incentives motivates owners to exertions that are sometimes lacking in larger firms. Generating employment and distributing income directly through employment can be more reliable than the now discredited tax-and-transfer-payment mechanism. Relying less on public-sector institutions and more on market principles lies at the heart of such a strategy.

The chapters that follow provide details on the present state and future possibilities inherent in a development strategy that uses small business as a key element. While economic advance and social equality always require effort to achieve, a focus on small business avoids many of the problems encountered by income-substituting industrialization. It therefore provides Ecuador and other low-income countries an attractive alternative for development.

CHAPTER TWO

FINANCIAL MARKETS POLICIES IN ECUADOR AND THEIR IMPACT ON MICRO- AND SMALL-SCALE ENTERPRISES

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INTRODUCTION

This chapter covers financial markets policies in Ecuador as they apply to MSEs. It describes the macroeconomic background in Ecuador that surrounds overall credit policies, discusses credit to MSEs in generic terms, and relates these generalizations to present Ecuadorean policies and impacts.

Macroeconomic Background

The Ecuadorean government's stated goals call for more investment, faster growth, and lower inflation. In practice, its policies have not been successful in reaching those goals. Like other Latin American countries, the debt crisis since 1982 has led to rates of growth lower than those experienced during the late 1970s. Macroeconomic adjustment mechanisms, both domestically and internationally, have led to lower growth, especially for low-income persons.

Financial markets and their credit creation in Ecuador, as in many other developing countries, operate in a context of inflation much higher than in affluent countries. Since the end of the oil boom and the beginning of the international debt crisis in the early 1980s, Ecuador has undergone two episodes of very high inflation, punctuated by a lessening in the mid-1980s. The consumer price index, as officially measured, rose by nearly 50 percent in 1983, increased by about 30 percent annually during the next four years, and then accelerated once again. In 1989, its increase was more than 75 percent. Details are shown in Table 1.

Inflation of this magnitude has come to Ecuador only in the present decade. Ecuador does not have the same history of price rises as Chile and Brazil do. Nevertheless, Ecuadoreans have, after a decade of experience, now learned to build inflationary price rises into their plans for investment and employment. The diminution in domestic saving and the nascent "dollarization" of the economy are consistent with these conclusions.

TABLE 1

ECUADOR: CONSUMER PRICE INDEX AND INFLATION, 1981-1989

Year	Cons. Price Index Annual Average	Cons. Price Index Year-end	Rate of Price Inflation (%) Based on Average	Rate of Price Inflation (%) Based on Year-end
1981	135.9	143.4	-	17.2
1982	158.1	178.4	16.3	24.4
1983	234.6	272.0	48.4	52.5
1984	307.8	340.2	31.2	25.1
1985	394.0	423.1	28.0	24.4
1986	484.7	538.8	23.0	27.3
1987	627.7	713.8	29.5	32.5
1988	993.2	1325.6	58.2	85.7
1989	1744.4	2044.7	75.6	54.2

Note: Index of consumer prices in the urban area for families of low and middle incomes.
Base: May 1978-April 1979 = 100.

Source: Banco Central del Ecuador, Información Estadistica Mensual, Julio 15 de 1990

Economic losses in growth and employment associated with inflation are only partially related to its height. Until the 1980s, Brazil grew rapidly in real terms at the same time that its rates of inflation vastly exceeded those of Ecuador.

Instead, the most dangerous aspect of inflation has been its unpredictability. Both long-term and short-term movements are involved. In the long term, there is a vast difference between an inflation that rises predictably at 20 percent a year and one that has a 50 percent annual rate. But if actors in the economy — investors, managers, employees, civil servants — do not know what the long-term rate is going to be, their economic behavior is unlikely to promote healthy growth.

Complaints from private enterprise about "tight money" are therefore amply justified. Under market-driven circumstances, a credit crunch of this magnitude would lead to high nominal interest rates and positive real interest rates. However, such an interest rate policy appears to be politically unacceptable. The result has been interest rates that were substantially negative in real terms.

This means, in turn, that demand for credit is even higher, and supply even lower, than would be the case if financially free markets determined the interest rate. Unsatisfied demand for loans rises as real rates become increasingly negative. Thus the diminution in the real volume of loans extended in the economy, coupled with a high demand for credit at negative real interest rates, reinforces the perception of tight money within the Ecuadorean economy.

When credit rationing occurs, the favored borrowers are likely to be big companies. Costs of servicing large, creditworthy borrowers are lower, and personal contacts are more frequent between bankers and executives in large enterprises.

Reserve requirements have not been a notable tool in the attempt to control the size of the money stock and thus the rate of inflation. In recent years, the Central Bank's reserve requirement on checking accounts in private banks has varied between 26 percent (1986) and 37 percent (briefly, at the end of 1987). In April 1990, the requirement was 32 percent. In short, it cannot be accurately claimed that the Central Bank has moved to ever higher reserve requirements in its attempt to control inflation. However, the high reserve requirements raise the cost of capital and have other important implications for bank behavior.

Interest rate controls and the variability of inflation have led to considerable uncertainty in financial circles. For example, uncontrolled inter-bank rates were far in excess of the prime rate (*tasa de libre*

TABLE 2

BANK CREDIT, BY SOURCE
(billions of sucres)

Year	Central Bank	National Dev. Bank	Private Banks	Total Nominal	CPI Deflator (Year-end)	Total Real	Index 1981=100
1981	46.3	14.1	56.9	117.3	143.4	81.8	100
1982	55.2	15.4	86.4	157.0	178.4	88.0	108
1983	107.0	23.0	143.8	273.8	272.0	100.7	123
1984	168.7	32.9	193.5	395.1	340.2	116.1	142
1985	184.2	48.1	214.3	446.6	423.1	105.6	129
1986	199.8	70.8	252.5	523.1	538.8	97.1	119
1987	238.5	85.8	327.5	651.8	713.8	91.3	112
1988	295.4	100.7	377.3	773.4	1325.6	58.3	71
1989	318.8	141.4	515.1	975.3	2044.7	47.7	58

Note: Year-end values. Real values in 1978-79 sucres.

PERCENTAGE DISTRIBUTION

Year	Central Bank	National Dev. Bank	Private Banks	Total
1981	39.5%	12.0%	48.5%	100.0%
1982	35.2	9.8	55.0	100.0
1983	39.1	8.4	52.5	100.0
1984	42.7	8.3	49.0	100.0
1985	41.2	10.8	48.0	100.0
1986	38.2	13.5	48.3	100.0
1987	36.6	13.2	50.2	100.0
1988	38.2	13.0	48.8	100.0
1989	32.7	14.5	52.8	100.0

Source for bank credit and CPI: Banco Central del Ecuador, Información Estadistica Mensual, julio 15 de 1990.

concertación) in December 1989, and again in March and May 1990. In mid-August 1990, they briefly touched 120 percent. Interest rates available to nonbank borrowers were, of course, even higher. Companies seeking to renew loans for working capital have little alternative but to pay these rates, although they may be refinanced if expectations later settle down.

These episodic increases in interest costs are incorporated into an inflationary mentality. People who fail once to prepare for unexpected inflation and interest rate jumps learn quickly to do so. They have now had plenty of lessons.

This means, in turn, that cutting the inflation rate becomes progressively more difficult. If increasing numbers of contracts are denominated in dollar-equivalents or are formally indexed, any increase in prices is transmitted quickly — in fact, nearly instantaneously — through the economy and becomes self-sustaining. The usual armory of weapons against inflation becomes less effective. The sacrifices that have to be made in such an environment become truly heroic. While no one suggests that Ecuador's problems match those of neighboring Peru, the proximity of that sober lesson should not be disregarded.

Under these circumstances, an economy cannot be disinflated overnight. The political attachment to "gradualism" of the present administration recognizes the nature of the problem. At the same time, there is little evidence that gradualism is working. The present rate of inflation of 50-60 percent per year, both predicted by some economists' models and reflected in nominal interest rates, is higher than it was at the end of 1989. No authority interviewed thought that much progress would be made in the short run. Even the present administration's ambitious goal of a 30 percent rate during the next two years would only bring inflation back to its rate under the previous government. And, as a reminder, two years of 30 percent inflation mean that prices at the end of the period are 70 percent higher than at the beginning. Two years of 50 percent inflation mean prices are two-and-one-quarter times higher than at the beginning.

The public policy dialogue surrounding inflation must continue for the sake of all Ecuadoreans, not only the part of the population associated with MSEs. Orthodox recommendations bear repetition:

- The fiscal deficit should decline. At present, fiscal policy has been run by monetary means. This is a fancy way of saying that conventional tax-hikes-and-spending-cuts have not been part of an anti-inflationary fiscal policy. Instead, only the varying speed of monetary expansion — now faster, now slower — has allowed the government to maintain itself financially; and

- A return to fiscal tools as such has important implications for change. Given the low levels of public investment, a decline in the fiscal deficit can only be accomplished by having fewer people on the payroll and by controlling the salaries of those who continue to be employed. The concentration of the public-sector employees gives them a political power out of proportion to their numbers which are considerable, thus making this alternative difficult.

Modern inflation is not merely a matter of excess demand, brought on by governments printing money to avoid being turned out of office. Expectations play a role in providing further momentum. On the side of supply, continued international liberalization of the economy means that competition from abroad can help discourage the worst excesses of local oligopolies. At the same time, the movement toward privatization (for example, of the state electric company, ENECEL) can help in improving output and productivity. Both these actions would reduce inflationary pressures.

Small-enterprise and Economic Development

The past decade has seen the defeat, in Ecuador and elsewhere, of import-substituting industrialization as a development strategy. The notion that local oligopolies should be protected from international competition in the hope that they might someday provide goods and services efficiently encountered problems. Some evidence suggests that, in certain sectors, the cost of imported inputs purchased by Ecuadorean firms actually exceeded the international price of the imported finished good. Such a situation was financially viable only with stiff protection for producers and correspondingly high prices for consumers.

At the same time that big local industrial firms were inefficient producers, they also contributed little to growth of employment and income. As they received imported inputs and capital on subsidized terms, they became import and capital intensive, at the expense of job creation and incomes for workers.

Rather than relying on trickle-down from big firms to solve growing problems of employment, many countries have embraced a strategy that focuses on small firms and that emphasizes international competitiveness. The two are not easy to achieve simultaneously, but when successful they produce incomes that support families directly. They are labor intensive. They do not use large amounts of imports as inputs. They provide an atmosphere of competitive supply in which output increases at the same time that oligopolistic profits and prices are eroded downward.

The observed changes in Ecuadorean development strategy have followed these lines, and in principle are positioned to reap the rewards inherent in a small-enterprise oriented strategy. The remainder of this chapter deals with a single aspect of such a strategy, namely, the domestic financial policies that surround it. Other chapters deal with Ecuador's labor policies and the country's international environment.

CREDIT POLICIES AFFECTING MICRO- AND SMALL-SCALE ENTERPRISES

The Ecuadorean government has undertaken a series of implicit and explicit policies that have an impact on the availability and cost of financial resources for the MSE sector. The credit policies that deal with loan eligibility and loan costs (interest rates) are treated in detail below. They are public policies of the GOE and of the international agencies and nongovernmental organizations (NGOs) who have correctly identified the activities of MSEs as one way to alleviate the problems of low productivity and low income at the grass roots level. To be sure, in a democratic society some public agencies may work with low-income groups merely to seek electoral advantage, but the decade-old consciousness of the desirability of directing programs to labor-intensive productive enterprise that involves competition (rather than, say, monopsonistic exploitation of labor) in both product and input markets reflects a step forward in civic and economic consciousness.

High Costs of Small Loans

Ecuadorean authorities have fashioned a set of credit policies that consciously set aside market principles. Table 3 shows the loan terms existing in August 1990 for some representative lending institutions. The interest rates are negative in real terms, and in addition the presence in some cases of grace periods and unusual loan maturities mean that the loans are made at submarket terms.

In fact, it is well known that costs of formal lending to MSEs are too high to allow unfettered market principles to be applied. Thus if Ecuadorean authorities and donor agencies want a higher volume of lending to occur, then some further element of subsidy will have to be injected into these credit markets. Formal lending is already subsidized, since real interest rates are below the cost of capital in formal markets and even further below the rates in informal credit markets, used heavily by MSEs.

Policies that Affect the Cost and Availability of Funds

Although the GOE has explicitly stated a desire to increase the level and effectiveness of funds available for lending to MSEs, many of the government's monetary policies have a negative impact on both the availability of funds and the cost of lending to such clients. Three specific policies that merit discussion are the reserve and rediscount policies of the Central Bank and the government's conscious or unconscious policy of substituting borrowed capital for domestic capital formation.

TABLE 3

LOAN TERMS OF REPRESENTATIVE INSTITUTIONS
August 1990

Agency	Interest Rate	Readjustable?	Longest Maturity (years)	Maximum Loan (million sucres)	Longest Grace Period (months)	Size limits on borrower	Req't for Counterpart financing
FOPINAR	48%	yes	10	21 (note 1)	36	25 mn FA 50 mn TA (note 2)	15-25%
CAF	48	no	7	8	24	20 mn FA	20%
Fondos Financieros	39	yes	2	11	none	25 mn FA	10-25%
FONADIA							
Working cap	39	no	2	10-32	none	12 mn FA	20%
Fixed assets	39	no	10	(note 3)	24		
UNEPROM							
Working cap	48	no	1	0.64	3-6	10 employees	none
Fixed assets	48	no	2	1.12		and 3.2 mn FA	
CONAUPE	39	yes	2	1.6 WC 3.2 FA (note 4)	none	K/L < 1.6 mn (note 5)	none
Fdn. Banco Popular	52	no	2	4	3	48 mn sales	(note 6)

General notes:
1. Readjustments in interest rates can occur as frequently as every quarter
2. Some size limits on loans and on eligible firms are stated in terms of numbers of minimum salaries. They are therefore automatically readjusted when the legal minimum salary rises.

Footnotes:
1. 15 million max. for fishing; 3 mn. max. for service enterprises
2. "FA" - fixed assets; "TA" - total assets
3. 10 for sole proprietors; 32 for companies with employees
4. "WC" - working capital; "FA" - fixed assets
5. Total capital divided by number of workers can't exceed 50 min. salaries
6. Enrollment fee: 30,000 sucres; tech. assistance fee: 20,000

Reserve Requirements

Setting reserve requirements is a means of both regulating the safety of the banking system and controlling the supply of money available for lending. Lacking other effective regulatory controls, the Central Bank of Ecuador uses high reserve requirements as the mechanism for regulating bank safety and controlling the money supply. At the present time, the reserve requirement is a very high 32 percent.[1] The Central Bank has not varied this rate significantly in the past several years.

[1]In comparison, the reserve requirement in the U.S. is normally between 6 and 12 percent of loans outstanding.

The high reserve requirement has two effects on credit, especially credit to micro- and small-scale enterprises. First, it restricts the amount of credit available in the system. Second, it increases the cost of funds. Both of these decrease the amount of credit available to small-scale producers. Thirty-two percent is a stiflingly high reserve requirement for a bank. With decreased liquidity, credit tends to be absorbed by larger clients and the amount of funds banks have available for lending to marginal customers declines. With higher costs of funds, banks can even less afford to subsidize MSE credits.

Rediscount Procedures

Rediscounting is a mechanism that allows financial institutions to use Central Bank funds (rather than their own) for socially approved lending programs. The bank or other approved financial intermediary makes a loan, then presents the documentation to the Central Bank, which reimburses the bank for the loan.[2] This reduces the amount of funds the financial institution has tied up in the specific lending activity, reducing the effective cost of loan. Two aspects of the Central Bank's handling of the rediscount process reduce the attractiveness and effectiveness of this approach.

Most rediscount programs rely on the prompt and automatic reimbursement of funds. The program in Ecuador is neither automatic, nor prompt. The Central Bank frequently "closes" the rediscount window, so that banks cannot be reimbursed for loans.[3] Neither are the rediscounts automatic or instantaneous; the Central Bank reviews each rediscount request and decides whether or not to approve it. Payments are delayed, sometimes for months. The result is that the banks do not trust the mechanism.

Because the rediscount process is designed to promote "socially approved" lending, the maximum interest rate on loans that can be rediscounted is fixed. At the present time the maximum allowed interest rate is 39 percent. This is considerably below the rate of inflation, market loan interest rates, and the cost of funds represented by interest rates the banks must pay on savings. As long as the banks are using Central Bank funds, this does not pose a major problem. As pointed out above, the rediscount process is neither automatic nor prompt, with the result that the banks face substantial risk of having to absorb the costs of below-market lending. In some cases the banks have established separate foundations, loaning them funds at 39 percent, and discounting the funds with the BCE so they have none of their own money at risk. The foundations can then charge realistic interest rates to the clients.

International Borrowing

There is an anomaly in that the GOE, while restricting the domestic money supply to control inflation, is borrowing hundreds of millions of dollars from international donors and flooding the

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[2]The rediscount procedure may vary in terms of qualification requirements, the proportion of the loan reimbursed, and the specific mechanics of the reimbursement procedures.

[3]At the time of the study, the rediscount line for small-enterprise lending was the only line being serviced by the Central Bank.

economy with special funds. This distorts domestic capital markets, reducing local capital formation and promoting capital flight, and is a direct impetus toward inflation.

Consequences

In summary, GOE monetary policies have the impact of (a) reducing liquidity in the private-sector financial system; (b) reducing the amount of funds available for social lending; (c) squeezing out small, low-profit loans; and (d) increasing the cost of operations, and creating and increased dependency on external, donated/loaned funds in lieu of internal capital formation.

Subsidies

Numerous subsidies for the borrower are incorporated in lending policies promulgated by the GOE. Among the more important are subsidized loan rates and subsidized search, training, and technical costs.

Subsidized Loan Terms

The qualitative nature of the Ecuadorean subsidies in small loans to MSEs can be readily stated. From a strictly financial point of view, these loans are usually made at interest rates considerably below market rates. The reluctance of profit-seeking Ecuadorean commercial banks to make small loans to small borrowers without extra incentives is notable. Extended grace periods before payments must begin and longer-than-market maturities of the loans (consistent with borrowers' reduced ability to pay) also lower the market value of the loan repayments.

Other Elements of Subsidy

Apart from these financial subsidies, the existence of more subtle costs facing borrowers lead public and donor institutions in Ecuador to engage in specialized and subsidized lending activities. The psychological discomfort in approaching "bankers" felt by unsophisticated small borrowers, the absence of a knowledge of bookkeeping and the customary but dysfunctional mixing of family finance and the small firm's finance, and lack of exposure to elementary marketing concepts — all mean that further Ecuadorean movement toward democratization or "massification" of credit will have to be subsidized.

Two other elements of subsidy are also present in the Ecuadorean institutional setting. The first of these is the subsidization of search and promotion costs in Ecuador's multi-agency setting. The second is a series of implicit and explicit subsidies of technical assistance and other support costs.

In Ecuador, a bewildering number of agencies have been established to transfer funds to the small borrower. Each agency has expressed its collective personality by formalizing a unique set of requirements, terms, and uses of funds. None wants to be considered thoughtless or merely imitative.

The predictable result is that borrowers confront a multiplicity of specialized institutions, some of which are well focused on their particular needs and others of which are not. The opportunity costs of searching for appropriate loan sources can be considerable. Time spent in looking for a loan is time taken away from other economic activity. Given the comparative advantage that small-scale producers have in production rather than in search, the potential costs of search can hardly be exaggerated.

These considerations lie behind the promotion activities of some of the Ecuadorean public agencies and NGOs. Because these institutions recognize, formally or not, that it is costly for small borrowers to seek them out, they go to the borrowers. The costs to borrowers are lessened, but the size of the transfer element in the eventual loan is increased. In short, while promotion can be desirable and effective, it is not free, even when borrowers themselves do not end up paying for it.

Beyond search and promotion, other nonmarket transfers have been included in Ecuadorean small-loan programs. Technical assistance is frequently mentioned. In some agencies, this is little more than helping the borrower to complete the necessary and potentially discouraging paperwork. In other cases, more substantive help with production, purchasing, marketing, and labor relations form part of the technical assistance package. In some cases, a charge for technical assistance is added to the amount of the loan; in others, it is rendered without charge to the applicant before the loan is granted and to the borrower once the loan has started.

Desirability of Income Transfers

To say that credit to MSEs in Ecuador is subsidized is not to condemn it. Only the most doctrinaire and superficial advocate of purest free enterprise would take such a position. Instead, the previous paragraphs have outlined the economic explanations for the necessity for subsidization if the formal lending activity is to occur at all.

At the same time, programs of low-interest loans to low-income families have a long history. When families use the loans to promote their own financial survival, and when some proportion of the beneficiaries is able to grasp the opportunities to raise their incomes and to provide employment for others, then the principle of subsidized loans becomes conceptually justifiable. At this point, the humane and intelligent agency will seek to make the transfers as cost-effective as possible, rather than discard the programs altogether because an initial element of subsidization happens to be involved.

Follow-up

Because of the absence of customary creditworthiness of many borrowers and the small size of the loans in absolute terms, considerable follow-up is necessary for both humanitarian and financial reasons. The lending agency wants the borrower to succeed. To the extent that it can render on-going advice through systematic monitoring of its loans, it is simply humane to do so. From a narrower financial point of view, follow-up with first-time unsophisticated borrowers is necessary to keep payment delays and defaults at a level that allows the lender to continue operation. Conversely, bigger loans to larger and more experienced businesses require less follow-up per unit lent. And again, although follow-up activities do not appear in a loan contract, they are a legitimate cost for a properly cost-conscious lending agency.

DEMAND FOR BORROWED FUNDS

Informal credit facilities do exist for Ecuadorean MSEs. Their demand for loans, like those of larger firms, is in part a function of interest rates. High interest rates for small firms lead to less demand for loans, simply because the underlying "investment" projects are not sufficiently productive (profitable) to pay the high charges. At lower interest rates and associated loan fees, more projects can generate the net operating revenues necessary to make the loan payments.

In short, the quantity of loans demanded at lower interest rates is higher than the demand at higher rates. It is therefore not surprising that there is excess demand for publicly sponsored low-cost credit.

FINANCIAL SECTOR INSTITUTIONS

Formal Agencies

Formal agencies that provide credit directly to MSEs include a wide variety of public and private institutions. Their number and the diversity of their interests prevents a complete accounting for their loans. The amount of credit extended by the two biggest credit providers, FOPINAR and the Fondos Financieros, are shown in Table 4.

TABLE 4

PRINCIPAL SOURCES OF FUNDS FOR MSEs
(Millions of sucres)

	Nominal		Real (note 1)			
Year	Fondos Financieros	FOPINAR	Fondos Finan.	FOPINAR	Total	Index 1981=100
1981	1,239	405	912	298	1,210	100
1982	1,755	636	1,110	402	1,512	125
1983	1,841	684	785	292	1,076	89
1984	2,782	1,177	904	382	1,286	106
1985	2,507	2,342	636	594	1,231	102
1986	2,509	1,593	518	329	846	70
1987	1,595	5,142	254	819	1,073	89
1988	1,189	4,079	120	411	530	44
1989	***	4,053	***	232	***	***

Note 1. Ecuador's consumer price index used as deflator. 1978-79 = 100 in that index.

Sources: Eliana Pozo M., "Lineas de financiamiento para la micro y pequeña industria," INSOTEC, July 1990; Folleto de informacion del FOPINAR, July 1990.

It has been estimated that all other formal providers taken together do not equal the loan volume of these two. And when compared with the total credit extensions in Ecuador, the amounts going through these formal channels to MSEs are about 3-4 percent of the total.[4]

The trend of credit available to MSEs during the 1980s was not upward, as the table shows. However, the BID allocation to CONAUPE of $30 million and the approved World Bank (fourth) credit to FOPINAR means that higher flows to small businesses will be available.

The two principal institutions in the formal financial sector that originate the credits to MSEs are the Central Bank which extends some of its Fondos Financieros administered by the National Development Bank to small-scale, but not micro, enterprise. The National Development Bank also administers the credits that go through the National Finance Corporation to one of its three agencies, the Fondo de la Pequeña Industria y Artesanía (FOPINAR).

The following is a brief introduction to the leading types of agencies active in extending credit to MSEs. The agencies are representative of the most important **observed outcomes of financial policies** stemming from actions of the GOE and donor agencies. Readers seeking further detail can refer to other sections of this report dealing with financial markets, donor agencies, and institutions.

- FOPINAR. FOPINAR has used World Bank funds to support loans for fixed assets (except land and vehicles), raw materials, and technical assistance for small industrial enterprise, business services, and fishing. Funds from a Dutch source (Corporación Financiera Holandesa, FMO) pay for the same items, but are directed toward micro-enterprise and artisans outside of Quito, Guayaquil, and Cuenca;

- Fondos Financieros. The Fondos were assembled by the Central Bank from international agencies (80 percent) and national funds (20 percent). They are used in a wide variety of economic sectors; they are not restricted to use in MSEs. Those loans that go to MSEs pay for raw materials, labor, and other operating expenses in small industry, artisan activity, tourism, fishing, and aquaculture;

- Corporación Andina de Fomento (CAF). Administered by the Banco Nacional de Fomento (BNF), these funds are used for fixed assets and raw materials in small industrial enterprises and artisan activity;

- Programa Nacional de Microempresas (UNEPROM). The Program works through the Ministry of Labor, using USAID funds. Its loans are used for fixed assets and working capital in micro-enterprises;

- Corporación Nacional de Apoyo a las Unidades Populares (CONAUPE). CONAUPE was established by the Borja government in 1988. It lends for fixed assets and working capital in "people's economic units" (*unidades populares economicas* [UPEs]) in the informal sector working only with productive "transformation" activities, that is, with manufacturing.

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[4]Eliana M. Pozo, *Lineas de Financiamiento para la Micro y Pequeña Industria.*

CONAUPE channels the loans of other intermediaries, including 11 private banks, rather than lending directly and holding its own portfolio; and

- Fundación Banco Popular. This is one of the newer foundations associated with a credit line of S/.500,000 extended in 1989 by the named parent bank. Makes loans in industry, commerce, and services. Lending activities until now localized in Quito.

The variety of institutions, sponsors, loan purposes, and beneficiaries is apparent, even in this short list.

At least in principle, private banks play a key role in retailing subsidized credit to MSEs. Agencies such as FOPINAR and CONAUPE are active in rediscounting loans solicited and made by private banks. At the same time, the attitudes of the banking community toward these loans is not unanimous. Some are active for political and public relations reasons. Many who have signed formal agreements (*convenios*) with the public agencies have never originated a loan.

Current banking regulations require that 10 percent of a private bank's lending portfolio be devoted to social loans, that is, to small loans and presumably to low-income borrowers. Avenues of evasion are many, however, and so the requirement is not effectively enforced. Because small loans yield less than larger ones, banks will logically seek to find more conventional borrowers.

Their excess reserves would therefore be exhausted, no matter what the level of required reserves.

Competitive Informal Credit Markets

Financial policies that seek to foment output and employment in Ecuadorean MSEs have not erased the vigorous informal credit markets. In fact, policy makers recognize that MSEs could not survive on the volume of credit currently extended by public or quasi-public organizations. So-called informal credit markets serving MSEs are well organized. Nevertheless, many observers talk as if small firms have no possibilities for credit and therefore that formal public agencies or NGOs must somehow fill a complete vacuum.

In fact, organized lenders are present for all size classes of firms. To small firms, small lenders make small loans at high rates. Their profits are not abnormally high; otherwise new lenders would enter the market and competition would drive down interest rates.

The high rates simply reflect high costs inherent in making small loans. Risks of default are higher, borrowers are unable to present project information or conventional financial guarantees, and big economies of scale are present in the administrative costs of lending, which small lenders cannot take advantage of. High costs of making small loans lead to high interest rates.

The high costs of information about a borrower's creditworthiness lead in turn to a spread of interest rates, all of which are high by any standard. Small borrowers in the informal market in Ecuador might pay 2-3 percent per week, or up to one percent per day, depending on local circumstances. Once again, more details of the implicit outcomes of these financial policies are provided in another section of this report.

INTERNAL INSTITUTIONAL POLICIES

Ecuadorean agencies that lend to MSEs have different policies with respect to the uses of their funds. Some lend to manufacturing, commerce, and services, while others restrict their activity to some subset of these activities. Some lend for working capital and for fixed assets, while others lend only for one or the other. Some focus their loans on small enterprise while others are willing to lend to micro-enterprise as well.

Micro-management

The most detailed set of limitations appears to be associated with loans by FOPINAR. The Fund's brochures mention the wide variety of activities for which the Fund is willing to consider loans. At the same time, the Fund refuses to lend for printing, baking, and confectionery. At an even more detailed level, publishers of books and notebooks cannot get loans from FOPINAR, but printers of industrial packaging can. New rice hullers cannot get loans, but existing hullers can seek credit to modernize their activities.

This degree of micro-management of borrowers' economic activities is based on a perception by the sponsoring agencies that some quite specific activities are saturated. In other words, the public agency interposes its judgment about the location of economic returns over that of the prospective borrower. The question of who has the most information about these activities is at least open to question. In a market system, if an investment project is well documented, then the presumption is that an economic gap exists, which could be profitably filled. To refuse to consider loan applications in such highly specified areas throws such presumptions away — to the economic detriment of borrower, lender, and community.

Guarantees

One of the most pervasive, and yet controversial, policies associated with formal loans to small borrowers is the requirement for guarantees. The guarantees can take the form of mortgaged property or other fixed assets or of a co-signer whose creditworthiness has been established. All the lenders we interviewed were quick to agree that the requirement for specific guarantees meant that loans could not go to would-be borrowers at the very bottom of the income pyramid, no matter how productive their investment project might be. Thus an internal contradiction in the program exists.

At least one author[5] has written that banks are more interested in the nature and quality of the guarantee than in the productivity of the proposed project. Presumably, they are willing to lend on some questionable projects if the collateral offered is sufficient.

Guarantee Funds

Because of the universality of the requirement for guarantees, guarantee funds have attracted some attention. They have been cooperatively financed by members of trade associations and by the Corporación de Retrogarantía. While cooperatives and trade associations face only the hurdle of limited funds with which to finance the guarantee fund, the same cannot be said for a public agency which seeks to step in to stand behind the small borrower. Unless the banking system is well policed, the existence of a public guarantee can lead to the extension of unproductive and inefficient loans, whose possibility of repayment by the borrower is low. The North American savings and loan crisis is the product of just such a publicly sponsored guarantee fund, and we should not forget that lesson when we consider policy alternatives in an Ecuadorean context.

OTHER CONSIDERATIONS

Concessional Element

The subsidized nature of formal loans to small business has been extensively discussed above. The concessional element in these loans need not be considered only in qualitative terms. A simple technique exists for the quantification of the amount of the so-called concessional element — that is, the size of the unrequited transfer — in any given loan. In verbal terms, to calculate the size of the concessional element we subtract from the size of the loan the present discounted value of the stream of loan repayments, using as a discount rate the opportunity costs of capital (roughly, a free market rate)

To make this calculation in the Ecuadorean context is more than an interesting exercise. In general, the concessional element of a loan is higher the lower the interest rate, the longer the maturity, and the longer the grace period. As concrete Ecuadorean examples, calculations reveal that a two-year loan at 39 percent with no grace period (the Corporación Nacional de Apoyo a las Unidades Populares Económicas [CONAUPE], for example) has a concessional element of 17 percent. That is, 17 percent of the loan represented a transfer to the borrower. By contrast a FOPINAR loan for 10 years with a 3-year grace period has a concessional element of 83 percent, even when a 48 percent interest is charged to the borrower. In this case, five-sixths of the loan is really a grant to the borrower.

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[5]Fernando Fernandez, *Condiciones de entorno de las pequeñas empresas en el Ecuador.*

Ability to Meet Credit Demand

An important policy issue that confronts donor agencies and others is the relative degree of achievable coverage in any of its activities, including loans to MSEs. How many firms are there, and how does that number relate to the amounts of funds from all sources likely to be available? While the calculations are derived from estimates, conservative calculations can lead to revealing results.

The universe to be covered is potentially all micro- and small-scale enterprises. They all need credit, almost by definition. No one knows how many there are in Ecuador. Estimates range from 450,000 to 715,000. Assume the lower number and suppose that one-third of these firms received a loan of S/.1 million (somewhat more than $1,000 at the present rate of exchange). Assume further that 50 percent of the loan amount is concessional. To support such a program, without including costs of administration, training, promotion, follow-up, or technical assistance, a total of S/.75 billion or $94 million would be required.

Stating the matter in another way, we might ask how many loans under the assumptions noted above could be provided with $1 million annually. The answer turns out to be 1,610 micro-enterprise loans, assuming that all ancillary costs were paid by local counterparts. That many firms compose 1.07 percent of the universe conservatively estimated at 450,000 enterprises.

In conclusion, the vast number of firms and the existence of a considerable concessional element means that coverage of subsidized loans will necessarily be scanty. The challenge to Ecuadorean policy makers and donor agencies is to change the parameters under which these highly simplified examples were calculated.

Minimalist and Holistic Approaches

Lending to small businesses in Ecuador is potentially expensive. Economies can be sought at each of the stages mentioned above, but the effectiveness of the lending operation can be impaired by unwise cuts in spending. The mix of services that should accompany loans is a matter of great controversy, and thus is among the alternatives that USAID must consider. Sometimes a two-way choice is posed between minimalist and holistic programs. While the following descriptions are intentionally abbreviated, they point out the differences. More detail is provided in another section of this report, but the following serves as an introduction to the important financial policy question.

Minimalists extend credit without ancillary services. Borrowers must find the agency, complete the application, invest the loan proceeds, and engage in regular repayment on their own, without much help from the lenders.

By contrast, holistic programs wrap loans in a package of prerequisites and post-loan services. Training, technical assistance, and detailed follow-up supplement the lending activity. All of the Carvajal-based foundations are examples of the holistic approach.

Each of the two approaches is fervently embraced by some agencies. Their continued coexistence and indeed competition is consistent with a variety of possible explanations. The explanations are not mutually exclusive.

- Borrowers are not homogenous. They differ by firm size, sex, economic activity, geographic location, economic sophistication, potential productivity, and profitability. It is therefore not surprising that lending programs should be as highly differentiated as the beneficiaries of the programs. One size does not fit all, nor is a single set of program characteristics going to be universally cost effective.

- Just as the borrowers are different, so are the lenders. The wide variety of degrees of financial sophistication, managerial effectiveness, technical know-how, and organizational experience means that lenders' programs are desirably variegated.

- Grassroots programs of lending to MSEs is not more than 10 or 15 years old. Participants — borrowers and lenders alike — are still learning how to do it right. Given their different observations, it is not surprising that a consensus has not yet emerged with respect to whether minimalist or holistic programs are better, despite the energetic claims by partisans on both sides of the debate.

Because these alternative approaches to overall loan policies are so sharply contrasting, USAID will inevitably be asked to choose between them. The foregoing remarks indicate, however, that each may have a legitimate place within the world of MSEs and donor agencies that is far from homogeneous. At the same time, more detailed studies of the agencies that will emerge as part of this GEMINI study should provide some empirical guidance on the matter, using observations taken from Ecuador's experience.

ECUADOREAN FISCAL POLICIES AND MICRO- AND SMALL-SCALE ENTERPRISES

An important tax reform was made in 1989. Without going into detail, under the new system, marginal rates on personal income vary from 0 to 25 percent. Different sources of personal income (for example, wages, dividends) are taxed equally. And an inflation adjustment is applied to interest received.

Corporate profits taxes were also reformed. The Development Law for Small Industry and Artisan Activity (Ley de Fomento de la Pequeña Industria y Artesanía) provides a series of attractive tax exemptions to formally constituted firms. Among them are the deduction from pre-tax profits of 75 percent of amounts reinvested during periods of up to 10 years. New investments are similarly favored. Accelerated depreciation schedules are also part of the law. Similar favorable treatment is legally offered to industrial parks and to investments in tourism, fishing, and agriculture, mining, and forestry.

The tax reform also incorporated indexing for inflation, a constant corporate profit tax rate of 25 percent, and a broadened coverage of indirect taxes through the value-added tax (VAT). It is difficult to estimate the extent to which these provisions will actually stimulate private-sector investment and growth. The relative absence of enthusiasm for use of possible tax exemptions under the previous tax law does not lead to optimism about the prospects under the reformed legislation.

These changes improve intersectoral financial flows, from activities of lower productivity to more profitably activities. The previous tax system favored retained earnings and discouraged dividends. The new system favors a greater degree of formality, in part because it can handle financial relationships between companies and individuals without tax system distortions. At the same time, the new system may lead to higher consumption (rather than investment), relative to the previous system's favorable treatment of retained earnings. Indirectly this favors small firms, since they are the ones predominantly oriented toward consumer markets.

Administrative reforms dealt with enforcing a withholding system, estimated income taxes, and the use of accounting data. Firms failing to comply with the law are subject to fines and interest payments on delinquent amounts. While informal firms will thus face stiffer sanctions for tax evasion, the additional costs of the required accounting systems and paperwork discourages movement toward formalization.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Renewed rates of inflation above 50 percent per year make planning investment and employment even more risky than before. The public has now thoroughly built inflationary expectations into their thinking. The anti-productive inflationary mentality affects the behavior of small firms as well as large.

> **Recommendation:** The GOE should continue to follow sensible policies to reduce the level and variability of inflation. Among these are a reduction in the fiscal deficit, continued export promotion and a reduction in subsidized import substitution, and an increase in supply, associated with the privatization of the largest and most over-staffed state enterprises.

Financial policy has eliminated preferential interest rates for big business. However, lending to small firms occurs at submarket rates and frequently includes packages of free services. In some long-term loans to MSEs, the concessional element is as high as 83 percent of the loan, without including the value of ancillary services. Even under the most efficient management, these concessional elements (transfer payments) are unlikely to disappear altogether.

> **Recommendation:** The GOE should continue its periodic readjustments of the preferential rates. At the same time, the GOE should recognize the magnitude of the transfers made from public-sector lenders to small borrowers under present regulations. The international donor community should recognize that loans to MSEs, while desirable for development purposes, are inherently expensive and are unlikely, even in the long term, to be self-supporting.

Borrowers face a bewildering variety of subsidized lenders, each with its own policies and terms. While wasteful duplication should be eliminated, the heterogeneity of borrowers and lenders makes complete unification of loan purposes and terms undesirable.

Recommendation: To help reduce search costs, a well-informed and well-publicized single source of information about lending possibilities for prospective borrowers should be established.

Lending to small borrowers is shunned by commercial banks because of the high costs of making and servicing the loans. While some banks have engaged in well organized small loan programs, there is no evidence that they scrupulously observe the legal requirement that 10 percent of their loan portfolios go for small loans.

Recommendation: Monetary authorities should explore ways to increase incentives for private sector participation in the organized development of MSEs.

Hundreds of thousands of firms participate in micro- and small-scale business. Even the most energetic program of credit extension is unlikely to reach more than a small fraction of potentially eligible borrowers.

Recommendation: A simple continuation of past programs by the international donor agencies and bilateral programs will not represent more than a drop in the bucket compared with conservatively calculated needs. While a continuation of these programs has obvious political appeal, realistic assessments about potential coverage should be made.

Important fiscal policy changes have been implemented. MSEs would be benefitted by a series of further changes.

- Small business should continue to enjoy tax exemption available under the previous laws. Of particular value are temporary tax exemptions associated with employment generation;
- Questions continue to exist about the cost effectiveness for the GOE of the new system of withholding taxes and estimated tax payments;
- Similarly, the uniform 25 percent rate of income tax on firms' profits has been questioned. For small firms, such a rate may be excessive;
- A provision in the new law forbidding the deduction of interest payments higher than those authorized by the Junta Monetaria should be eliminated, since small firms' use of informal credit markets expose them to much higher interest rates — payments that should be legitimately deductible;
- The tax system should favor reinvestment from retained earnings, since financial markets are not well developed; and
- Compliance and receipts by the Treasury would be improved by the extension of general training courses in the provisions of the new law, coupled with greater penalties for tax evasion.

CHAPTER THREE

LABOR MARKET POLICIES: IMPLICATIONS FOR MICRO- AND SMALL-SCALE ENTERPRISES

by

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THE LABOR MARKET STRUCTURE

Population growth in Ecuador is 2.2 percent annually, equal to the 2.2 percent average in Latin America. Although overall population growth is not perceived as an overwhelming problem, some demographic trends cause concern. First, urban population is growing much faster than total, due to rural-urban migration. Second, the economically active population (EAP) is growing at a much faster rate than total population (3.2 percent annually). And last, three out of four jobs needed to employ labor-force entrants will have to be created in the urban area if the present trend continues.[1] As a consequence of these demographic and economic trends, the share of urban population in the total population is increasing rapidly, and the share of urban EAP in total EAP is rising even faster.

Previous research on strategies for employment generation suggests that a two-pronged approach to the employment problem should be adopted.[2] On the one hand, creation of meaningful employment in rural areas and secondary cities is needed to reverse, or at least

TABLE 1

SOME DEMOGRAPHIC INDICATORS

1990			
Total population			
TOTAL	10,781,600		
Urban	5,902,200	54.7%	
Rural	4,879,400	45.3%	
Average annual growth rate (in percent)			
		1974-1982	1980-1990
Population growth		2.8	2.2
EAP growth		2.9	3.2
Percent Urban			
1950	28.5	(Census figures)	
1982	48.9	(Census figures)	
Economically Active Population			
TOTAL	3,365,000		
Urban	1,940,300	57.7%	
Rural	1,424,700	42.3%	
Females as Percent of EAP			
Total	23.4		
Urban	28.2		
Rural	12.0		

Source: CONADE-UNFPA, "Población y cambios sociales" [1987]

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[1] Lehman Fletcher, *et al.*, 1988.

[2] *Ibid.*

slow down, the increase in the proportion of urban population and EAP in total. At the same time, special efforts must be dedicated to the creation of meaningful employment opportunities in the urban areas.

The urban employment problem is usually interpreted as being one of high and rising unemployment. However, available evidence contradicts this view: urban unemployment rates are low (about 7 percent by the last INEM survey), and historically do not show any rising trend. Low productivity and low-wage jobs, however, are an extended trait of the urban labor markets given the large concentration of employment in the informal sector and, in general, in MSEs.

More than 40 percent of the urban labor force has a job in the informal sector of the economy, defined here as the sum of employment in enterprises with less than five workers and self-employed workers in occupations other than directive or professional. Looking at the employment structure by firm size, more than 60 percent of all jobs are located in enterprises with less than 20 workers

TABLE 2

STRUCTURE OF EMPLOYMENT BY SEGMENT OF THE LABOR MARKET

Urban areas - 1988		
Percent Employed in		
Modern sector	46.8	
private		28.1
public		18.7
Informal sector	41.4	
self-employed		22.0
employer		5.4
paid family worker		3.7
ME employee		10.3
Agric.+dom.serv.	11.8	

Source: INEM Household Survey (Nov. 1988)

Furthermore, a full one-third of employment in these MSEs is self-employment. MSEs thus account for an important fraction of urban employment and are responsible for most of the jobs created during the downturn of the Ecuadorian economy since 1982.

Income differentials between the modern and informal sectors are large at all educational levels, decreasing only for the small number of informal-sector workers that have completed university education. As has been extensively discussed in Fletcher et al. [1988], this suggests the existence of segmentation in the labor market, where equally productive workers receive very different income levels depending upon the segment of the labor market in which they have a job. Restricting our attention to the manufacturing sector covered by the INEC annual survey (which excludes MSEs), labor costs represent only 9.3 percent of total production costs, and slightly over a third of total value added on average. The proportion of labor costs in total value added and earnings-per-employee both tend to grow with firm size, suggesting that higher-quality jobs tend to be concentrated in larger enterprises.

This quick review of data shows that urban labor markets in Ecuador are segmented, in the sense of enormous income differentials existing among equally productive workers because of their affiliation with enterprises in different segments of the labor market (private modern, public modern, and informal).

TABLE 3

THE STRUCTURE OF URBAN INCOME DIFFERENTIALS BETWEEN MODERN AND INFORMAL SECTORS
(Wages in Current Sucres)

Educational Level	Modern sector	Informal sector	Differential Percent
None	32,898	16,967	193.9
Some Elementary	34,401	22,148	155.3
Complete Elementary	37,030	29,373	126.1
Some Secondary	38,908	26,975	144.2
Complete Secondary	48,315	35,977	134.3
Some University	51,367	34,091	150.7
University Degree	73,358	66,566	110.2
Average	48,044	29,165	164.7

Source: INEM Household Survey (Nov. 1988)

Although time series data are not available, there is some evidence of stagnation in job creation, in the sense that high productivity, modern-sector jobs (in manufacturing and associated high productivity service activities) have not grown in numbers since the beginning of the 1980s. On the other hand, both segmentation and stagnation transform labor markets into poverty-generating machines, in the sense that most workers earn low incomes and work under insecure industrial conditions (mostly in MSEs).

The reasons for this dismal performance of the labor market are multiple. The capital, labor, and goods market distortions created under Import Substitution Industrialization (ISI) strategy lowered the price of capital (through over-valued exchange rates, subsidized interest rates, and fiscal incentives for investment), and increased the price of labor (through specific payroll taxes and working conditions regulations). Furthermore, modern and visible firms must comply with labor market regulations that impose severe penalties for firing employees, thus converting employer-employee relations into a relationship that resembles a marriage. In an unstable macro-economic environment, profit opportunities must be huge before a firm decides to expand employment. Therefore, the prices that economic agents receive push them toward the choice of capital-intensive technologies, thus lowering employment generation and increasing the demand for capital.

TABLE 4

MANUFACTURING INDICATORS - 1988

Firm Size	Percent of Employment	Labor Costs as Percent of GVP	Labor Costs as Percent of Value Added	Earnings per employee (S/.000)
Total	100.0	9.3	34.4	961.3
10 - 19	6.6	8.0	27.8	488.6
20 - 49	15.4	7.4	23.8	649.4
50 - 99	14.8	8.9	32.4	891.5
100 - 199	17.0	9.6	32.9	1,003.1
200 - 499	24.3	10.1	35.9	1,148.9
500 and more	22.0	9.9	44.4	1,127.5

Source: Encuesta annual de manufactura y mineria, INEC 1988

Given the ensuing capital market rationing, those agents not powerful or influential enough to have access to fiscal subsidies (including workers who could not find a modern-sector job), create income-earning opportunities in the informal sector. Just because of their lack of access to capital, these jobs tend to be low-productivity, low-income ones. As large income differentials between modern (visible) and informal (invisible) sector jobs arise, unions respond to economic incentives by increasing even more the economic penalties for releasing employees.

Informal and invisible economic units find a competitive advantage in evading labor regulations, thus becoming the most dynamic segment of the labor market in terms of employment generation. But they do so at the cost of workers' welfare, both in the sense that they pay substandard wages, and in the sense that job-security regulations are ignored. Even if MSEs provide employment to the needy, this welfare loss must be somehow acknowledged.

THE REGULATORY FRAMEWORK

The *Código del Trabajo* (CT) was enacted in 1938 and amended in 1961, 1971, and 1978. The CT is extensive and complex. It includes regulations about the form of the labor contracts, the organization of work within the firm, the level of wages and mandatory fringes, the conditions for hiring and firing, union organization, industrial security, procedures to deal with collective contracts and conflicts, and a host of other issues related to labor utilization by the firms.[3]

As is common in the hispanic legal tradition, the CT dispositions include detailed prescriptions and prohibitions on practically every imaginable issue. These dispositions are based on legal principles that state that workers are in an economic disadvantaged position. Labor laws should enhance their bargaining power through (1) imposition of mandatory fringe benefits, and (2) nonrenounceability of CT dispositions. Thus, labor laws are conceived as a protective device, where workers should be given the upper hand in any situation where firms could use their economic advantage. Though this often violates the principle of legal equality, it is important to realize that the starting point of labor legislation is the recognition of workers' economic inequality.

Even if it can be argued that the legislation evolved from these first principles, and that the principles themselves were copied from legislation enacted in the more-advanced European countries, it must be recognized that the CT was consistent with national development goals all too common to Latin American countries. The development of an incipient urban work force demanded by import-substituting industries, jointly with the need to create a domestic market, made highly functional any disposition that could enhance the buying power of employed workers.[4] The common populist, anti-business position of governments, made politically viable the enactment of this type of labor regulation.

Furthermore, an economic rationale for the enactment of labor regulations was soon to be found in the work of Raúl Prebisch, who for long period of time held a dominant theoretical influence in

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[3]For a more detailed description of Labor Code regulations see Annex 1 to this chapter.

[4]Dipak Mazumdar argues that efficiency-wage arguments can be used to explain why it was also functional for modern firms to accept high-wage costs in exchange for lower turnover.

ECLA's promotion of import substitution industrialization (ISI) policies. In his original paper (1949), Prebisch attributed the secular deterioration of terms-of-trade facing Latin American countries (LACs) to the power of workers in developed countries to retain productivity increases in the form of higher wages, while LACs' unorganized and unprotected workers felt the pressures of excess supply of labor in the form of stagnant wages. As a result, products in developed countries increased in price, whereas in lesser-developed countries (LDCs) products fell in value, resulting in a deterioration of terms of trade. In this sense, labor laws enacted at the time in Ecuador and in many other LACs form an integral part of the ISI strategy.

The Effects of the Labor Law on Employment Generation

Labor laws are frequently blamed for the failure of ISI policies to generate sufficient employment in LDCs. However, this view is partial and simplistic. First, ISI policies generated distortions not only in the labor market, but also, and maybe mainly, in the capital and goods markets. Second, the labor law regulations encompass different kinds of workers' rights. Some form part of what today are considered universal human rights, while others treat specific norms with important effects on employment generation.

On the first issue, the adoption of excessively capital-intensive technologies is due both to an artificially high price of labor, and also to an artificially low price of capital.[5] High-wage rates result from labor law regulations that increase the price of labor above market-determined wages, while low real interest rates come from subsidies to imported capital goods, tax holidays on investment, subsidized interest rates, and over-valued exchange rates. The fact that goods markets are oligopolistic also had a bearing on this, given that capital-intensive technologies permitted excess production capacity, a defensive device used by oligopolies to raise entry costs and dissuade potential competition. Blaming the employment problem just on one element of this complex causality is superficial at best.

On the second issue, Portes' position is extremely useful.[6] He distinguishes between different rights among those included in the labor law regulations. Basic protection of health and industrial security conditions, protection to women and child workers, and right to free association and expression of grievances seem to be minimum-standard conditions that every government should seek to enforce effectively. Wage-and-hour rights (including right to a limited workweek and minimum wages), however, and job-security rights (including mandatory severance payments) are more responsive to local conditions, and should be considered separate issues.

Wage-and-hour rights affect variable labor costs and in that sense potentially reduce labor demand. A profit-maximizing firm will hire labor up to the point where the value of the marginal product of labor (VMPL) equals the market wage. Minimum wages and limitations on workday and/or workweek length, paid holidays, and so forth, by affecting wages and effectively worked hours, also have an

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[5]The word excessive is used here to mean that factor intensity does not reflect the scarcity market price of inputs to the production process.

[6]Alejandro Portes, *When More Can Be Less: Labor Standards, Development, and the Informal Economy.*

impact on variable labor costs. Therefore, the take-home pay of unskilled workers will be their market wage rate minus the costs of all fringe benefits. If the minimum wage plus the costs of fringe benefits exceeds the marginal productivity of unskilled workers, then unskilled workers will become unemployed until the wage/VMPL equality is restored. With distortions in the capital and goods market, however, results will depend on the direction of policy biases in all markets, not just in the labor market.

Job security rights, however, convert labor into a quasi-fixed factor. When mandatory severance payments or outright firing prohibitions exist, the decision to hire an additional worker hinges on whether the VMPL exceeds wage plus fringe benefit costs plus termination costs. When termination costs are substantial, they deter employment generation by increasing labor costs.

But the effects of job-security rights go well beyond this. Without mandatory severance payments, firms that face a transitory demand expansion will increase employment because the VMPL has increased. Such firms are not affected by the expected duration of the demand expansion; to the extent that they can hire and dismiss workers following the demand cycle they will do so. As a consequence, intersectoral labor mobility will lead to an appropriate use of labor. Obviously, skill specificity will hinder intersectoral displacement and so specific and general training and retraining are needed for the labor market to operate smoothly.

With severance payments, however, the firm faces one additional constraint: the shorter the expansion of demand is expected to last, the shorter the period over which severance payments must be amortized, and the higher the VMPL must be to induce the firm to hire an additional worker. Thus, the decision to hire an additional worker hinges crucially on the macro-economic conditions affecting the firm's demand. The more unstable the macro-economic environment, the higher the expected profits must be to induce firms to expand employment, and the more unemployment and underemployment will persist. Instability characterizes the macroeconomic situation in the LACs during the last decade.

As a conclusion, in the analysis of the effects of the labor law on employment generation careful distinction should be made between (1) protective dispositions, (2) minimum wage and mandatory fringe benefits, and (3) job security and mandatory severance payments. Protective dispositions are, in principle, justifiable on grounds of respect to minimum standards of workers' welfare and security that have come to be embraced by democratic societies. By contrast, in an unstable macroeconomic environment, it is clear that job security and mandatory severance payments are bound to have a deleterious impact on employment generation, much larger than that of minimum wage plus fringe benefits.

An Application to the Ecuadorian Case

Protective Dispositions

The Ecuadorian CT makes abundant dispositions that fall into the class of protective devices. Special sections of the CT are dedicated to women's and children's working conditions.

The act of hiring is strictly and formally regulated. Employer and employee obligations are enumerated in a quite detailed way. Both fixed-terms and indefinite-employment contracts have a minimum duration of a year. The probationary period is limited to a maximum of 90 days, and no more than 15 percent of the total number of workers can be on probation in a given establishment. After the probationary period, labor contracts are automatically in force for the rest of the year.

Working conditions (internal regulations, work schedule, industrial security, and so forth) must be approved by the Ministry of Labor, and can be modified by a workers' petition to the Ministry. Limitations to managerial prerogatives can even restrict moving a worker to a different occupation than the one he was hired for.

Dispositions regarding work schedules are various. First, there is an 8-hour daily, 40-hour weekly ceiling on working time. Second, the night shift begins at 7 p.m. and ends at 6 a.m., hours that must be paid with a 25 percent premium over normal wage. Third, overtime is limited to 4 hours daily and 12 hours weekly, and is paid at a premium of 50 percent over normal wage. Finally, all workers are entitled to 15 days (including nonworking days) of vacation per year, with an additional day per year of tenure after 5 years.

Workers are strictly protected from the economic consequences of work accidents by establishing primary responsibility of employers, substituted only by Social Security coverage. However, all employers are obliged to register their workers at the Instituto Ecuadoriano de Seguro Social (IESS) where they obtain medical insurance plus credit benefits.

Workers have the right to organize unions in establishments employing more than 15 workers. These unions can engage in collective bargaining. In case of collective conflicts, the right to strike is guaranteed after an established procedure. Collective labor conflicts are solved by an organism composed of workers, employers, and the government, with the latter having decisive power.

In general, it can be argued that some protective dispositions of the labor law reduce greatly the prerogatives of managers in organizing work within the firm, by establishing a strict limit on the length of the work day and organization of tasks within the firm. Two aspects merit special attention. The first is related to the duration of the probationary period, which seems quite short for some occupations where special skills must be exercised. The second relates to the limit of 15 workers for union organization, which seems low given the overall size distribution of establishments. An increase in this minimum could act to protect smaller (presumably less profitable) enterprises from union demands.

Except for the limitations on hours of work, it is difficult to establish in general the costs of these regulations for firms. However, costly as it may be, adherence to some minimum standards of industrial safety is a must if one is to protect workers from health hazards. In the same sense, right to organize unions does not necessarily impinge negatively on productivity or profitability. Worldwide evidence is not uniform, but nothing indicates that in Ecuador this right has a particularly negative effect on productivity or profitability.[7]

[7]Except in the public sector, where mismanagement, not unions, seems to be the main result of some outrageous collective contracts.

Regulations that Affect Variable Labor Costs

Most of what we called wage-and-hour rights have direct effects on the cost-per-hour of labor. In this section we calculate the cost-per-hour of an unskilled worker, earning the minimum wage after taking into account the cost of fringe benefits and reduction in work hours during the year. Our cases will be an unskilled and a semi-skilled worker at the end of their second year of employment in the firm.

By these calculations, mandatory fringe benefits account for an additional 95 percent and 58 percent of basic salaries of unskilled and semi-skilled workers. The calculations exclude the reserves for mandatory retirement benefits *(jubilación patronal)*, since they only constitute accounting reserves that the firm may use to finance working capital.

The dollar cost-per-hour looks low by international standards, although above that of low-income Asian countries. However, the international comparisons may not be meaningful, given productivity differentials that affect the cost-per-unit of production, which is the relevant variable for international cost comparisons. Nevertheless, the end result indicates that including fringe benefits, dollar cost-per-hour reaches up to $0.49 and $1.19 (from $0.25 and $0.75 including only basic salaries) for unskilled and semi-skilled workers. These values do not lend too much credibility

TABLE 5

THE COST-PER-HOUR OF WORKERS

Worker A, the unskilled worker, was hired two years ago, and is earning the minimum wage. Worker B is a semi-skilled worker and is earning three times the minimum wage. Mandatory minimum wage for worker B is S/.50,000 per month. To simplify calculations, assume that:

1) no overtime or night shifts have been worked during the previous year,
2) firm's liquid profits (utilidades) are such that it is required to pay workers two monthly wages per year in profit sharing.

	Unskilled Worker A	Semi-skilled Worker B
Salary	384,000	1,152,000
13° sueldo	32,000	96,000
14° sueldo	64,000	100,000
15° sueldo	50,000	50,000
Profits	64,000	192,000
Comp. Bonus	12,000	0
Transportation	38,400	0
Cost of Living	30,000	0
Social Security	41,664	124,992
SECAP contribution	1,920	5,760
Reserve Fund	32,000	96,000
TOTAL LABOR COST	749,984	1,816,752
	divided by	
TOTAL HOURS WORKED	1,912 hs.	1,912 hs.

(40 hs. weekly times 52 weeks, minus 11 working days in vacation time, minus 10 national holidays)

COST-PER-HOUR	392.25/hour	950.18/hour
or	0.4903 US$/hour	1.1877 US$/hour

(calculated at an exchange rate of S/.800 per US dollar, approximately the intervention exchange rate for import/export operations) to the contention that labor cost is the single most important problem hampering employment generation and international competitiveness in Ecuador.

The Impact of Job Security Rights on Labor Costs

As mentioned in the previous section, the impact of mandatory severance payments and job security rights on labor costs differ greatly from that of mandatory fringe benefits. While mandatory fringe benefits increase variable labor costs, job security rights make it difficult for the firms to adjust to unfavorable shifts in demand.

Two forms of severance payments must be distinguished. The first, included in the CT, establishes that firing notice must be given with 30 days in advance, and that a severance payment calculated as 25 percent of the current monthly wage per year of worker's employment must be paid. Additionally, in case of layoffs without notice *(despido intempestivo)* the firm must pay the worker a severance payment equal to 2, 4, 6, or 12 months of wages according to worker's tenure of less than 2, between 2 and 5, between 5 and 20, or more than 20 years. The second, established since 1979 with each wage raise decree, establishes that workers cannot be fired except for just cause. If the firm chooses to fire a worker, a severance payment — one year of wages for workers with less than three years of employment, or two years of wages for workers with three or more years of employment — is due under the law.

The second form is binding for employers under the dispositions of Decree 1066/89 enacted by the present government. To understand its impact on labor, assume first that a firm perceives an increase in demand. Half the managers feel that the increased demand is going to last just for a year, and the other half think that it is a permanent expansion in demand. Without severance payments, the firm would compare the VMPL of an additional worker with the cost of hiring him/her (calculated in the last subsection as \$0.49 and \$1.19 per hour for unskilled and semi-skilled workers).

With severance payments, however, that calculation must also include the value of the expected severance payment spread over the number of months the firm expects demand to be high. In other words, the cost-per-hour of the worker now is equal to basic salary plus fringe benefits plus total severance payments divided by the number of hours the firm expects to need the worker. With a probability of one-half demand will return to its original level at year's end, and the firm will have to fire the worker and pay him/her one year of basic salary. With a probability of one-half demand expansion is permanent and the firm will keep the worker. Thus, the expected value of severance payments is equal to the average of one year of basic salaries (the firm fires the worker) and zero (the firm keeps the worker and does not pay any severance). Call this case Worker A, calculated on the basis of the unskilled worker.

But there is another interesting case. Assume now that a firm faces a falling demand. If the firm has workers with three years of tenure (because demand was previously stable), now the expected value of severance payments is the average between the value of two years of basic salaries (the fall in demand is permanent and the firm fires the worker) and zero (demand keeps its level and no worker is fired). Call this case Worker B, calculated also on the basis of the unskilled, minimum-wage worker.

First, note that in the case of Worker A, where the firm is deciding whether or not to hire a new worker, cost-per-hour increases 26 percent over basic salary plus fringe benefits. Thus, the firm will reduce its hiring in comparison to the situation without mandatory severance payments. Secondly, note that if the firm is facing a downward shift in demand and has a stable work-force, adjustment to the new situation will cost it more (51.2 percent over basic salary plus fringe benefits) than if it had a high turnover work force (in which case it will only cost it 26 percent over basic salaries plus fringe benefits).

TABLE 6

COST-PER-HOUR-OF-LABOR UNDER JOB SECURITY RIGHTS

	Worker A	Worker B
Basic salary cost-per-hour	200.84	200.84
plus Fringe Benefits	191.41	191.41
TOTAL WITHOUT SEVERANCE PAYMENTS	392.25	392.25
plus Expected value of severance payments (the average of one year of basic salary for Worker A, or 2 years of basic salary for Worker B, and zero)	100.42	200.84
TOTAL WITH SEVERANCE PAYMENTS	492.67	593.09
or	$0.6158	$0.7414

Thus, firms with high turnover will be able to adjust more readily to adverse demand conditions than firms with a more stable workforce. As a consequence, firms do not have incentives to retain workers nor to train them. In both cases, retaining or training, firm's ability to adjust to adverse conditions is reduced.

From the workers' perspective, the present system of mandatory severance payments acts also in a perverse way. If workers remain for a long period of time with a firm, their take-home pay is reduced from what it would be if a worker is fired. The workers' relevant comparison is between the wage they will get by remaining at the firm and the wage they could get elsewhere plus the severance payment. This implies that firms willing to retain workers must pay a premium over market wages (the wage the worker can get elsewhere, possibly in the informal sector). As a consequence, either workers' incentive to remain long periods of time within a firm are reduced, or firms' labor costs are increased, not because of fringe benefits, but because of the negative incentive effect of severance payments.

THE IMPACT OF LABOR REGULATIONS ON MICRO- AND SMALL-SCALE ENTERPRISES

Interpreted literally, the dispositions of the Labor Code create an enormous disadvantage for MSEs under the assumption that they use more labor-intensive technologies than big firms. These disadvantages arise from two sources:

- Higher labor costs have larger effects on more labor-intensive firms' costs; and

- MSEs operate in more unstable and competitive markets, and thus have higher costs associated with layoffs.

Minimum-wage determination differentiates between large and small firms. Currently, the general minimum wage is S/.32,000, and small enterprises' minimum wage is S/.29,000. The Minimum Wage Commissions (*Comisiones Sectoriales de Salarios Mínimos)*, which fix minimum wages at a more-detailed economic activity and occupation level, also differentiate between MSEs and large firms. The differentiation is far from complete: out of 117 activities regulated by these comisiones, differentiation between MSEs and large firms is made only in 52 sectors.[8]

MSEs, however, tend to not comply with labor regulations by being invisible and informal, thus evading the weak enforcement mechanisms. The public-sector institutions involved in supporting MSEs admit quite candidly that MSEs do not comply with labor regulations and, besides, that they institutionally do not make any effort to enforce compliance with the law. This is, at the least, a curious attitude from organizations involved in transferring resources toward what they perceive as being a neglected segment of the economy.

In the survey made for this study, 7 percent of interviewees answered that the Labor Code had a negative effect on their activities, a full 58 percent said it did not affect them, while the rest did not have an opinion (presumably part of this group simply ignored the existence of the Labor Code). These results did not vary when controlled by firm size (measured by total employment). Those who said it did not affect them were evenly spread across firm by size.

For MSEs the main effect of labor regulations is on their growth. When MSEs face expanding demand conditions, their cost of growing is far larger than that faced by bigger firms. Firstly, they have to become law-abiding firms, thus dedicating part of the scarce resources of the firm to dealing with red tape *(trámites)* both at registration time and every month after. Secondly, they must comply with labor regulations, thus increasing labor costs and introducing (previously nonexistent) industrial security devices and systems.

Evaluating the costs of industrial security systems can be complex so the calculations deal only with labor costs. Assume that two firms operating in the same activity face a demand expansion. The first firm is an informal and invisible firm employing five workers at wages below the minimum wage. More precisely, assume that the firm pays its workers a fraction of the minimum wage equal to that which informal firms paid workers with no education in November 1988 (obtained from the INEM survey). This implies that the informal firm today pays S/.26,312 monthly, roughly 10 percent below the legal minimum wage for small enterprises. Being informal, it does not comply with labor regulations. Thus, it does not pay any fringe benefits to its workers and does not make any provision for severance payments. The modern firm, by its part, pays the minimum wage of S/.32,000 monthly, pays fringe benefits to its workers, and makes provisions for severance payments.

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[8]Fernando Fernández, *Condiciones de Entorno de las Pequeñas Empresas en el Ecuador.*

Facing a demand expansion, both firms have to make decisions regarding employment expansion. For the informal firm, expanding employment implies becoming visible, with the consequent obligations to (1) pay minimum wages to all its workers, thus increasing labor costs by the wage of the newly hired worker plus the wage increase up to the minimum for the already-employed five workers; (2) pay mandatory fringe benefits to all its workers; and (3) make provisions for severance payments to the newly hired workers. The modern firm, on its part, undergoes an increase in total labor costs because of the costs associated with the newly hired worker, but not for additional costs of the old workers.

Even if the informal firm legally pays a lower minimum wage than the modern firm, its cost of hiring a new worker and becoming visible is three times higher than the costs faced by the modern firm. If we take into account that informal firms tend to be more labor intensive than modern firms, it is clear that they face a larger increase in cost affecting labor, thus making for a bigger proportional increase in total costs.

Now, for many MSEs, particularly for the smallest ones, this increase in costs is unaffordable. Besides, given their small size and the limited market opportunities they face, it is not in their interest to grow and become visible. No amount of credit or technical assistance will make these firms profitable enough to become formal and comply with labor regulations. Thus, the government's attitude of ignoring the fact that these firms do not comply with labor regulations appears to be sound.

TABLE 7

THE DIFFERENTIAL COST OF EXPANSION FOR INFORMAL AND MODERN FIRMS
(Annual Values in Current Sucres)

	Informal Firm	Modern Firm
Yearly Cost-Per-Worker Before Expansion		
Basic salary cost	315,749	384,000
plus		
Fringe benefits	0	365,984
plus		
Exp. severance payments	0	192,003
TOTAL	315,749	941,987
Cost of Adding an Additional Worker and becoming visible		
Basic salary costs		
for new worker	348,000	384,000
for old workers	161,252	0
plus		
Mandatory fringe benefits		
for newly hired worker	331,673	365,984
for old workers	1,658,365	0
plus		
Exp. severance payments	174,000	192,003
TOTAL COST INCREASE	2,949,840	941,987

However, there is a small number of MSEs that, either because they face more favorable market opportunities or because they have a more structured technical and organizational layout, could afford the cost increases associated with labor regulations compliance. This small number of MSEs could profit from expansion if in doing so they improve their access to formal credit systems and to more complete marketing and technical information systems. This implies that specialized support programs should be designed to address the needs of this group, even if these programs do not address the needs of the poorest of the poor within the sector.

LABOR UNION ACTIVITIES

Labor unions in Ecuador are establishment based, and can be legally constituted in establishments with more than 15 employees. The labor law provides that the relevant unit for union formation is the establishment, not the firms. For example, no union can be formed in a firm with a total of 39 employees, dispersed in 3 establishments with 13 workers each. These establishment unions can be affiliated to provincial federations, which in turn affiliate to a national confederation. Unions are financed by contributions paid by the employer (.5 percent to the local federación, .5 percent to the national confederación) and by workers' payroll deductions.

Four main ideologically oriented national confederations exist in the country:

- Confederación Ecuatoriana de Organizaciones Sindicales Libres (CEOSL), left-of-center social democrats with an estimated membership of 35,000 workers. It was expelled from the CIOSL (AFL-CIO) because of its leftist position;

- Confederación de Trabajadores del Ecuador (CTE), socialists and communists, with an estimated membership of 10,000;

- Central Ecuatoriana de Organizaciones Clasistas (CEDOC), moderate socialists; and

- CEDOC-CLAT, a social-Christian off-spring of CEDOC.

These four confederations are organized in a political coalition, the Frente Unitario de Trabajadores (FUT). The four groups occupy by turns FUT's chair. Presently, it is CEDOC's turn. Two national federations affiliated with CEDOC, FENACOMI and FECMA, group informal-sector commerce workers in municipal markets.

According to the Ministry of Labor, 206,000 workers work under union-established collective contracts. Of these, 106,000 belong to the public sector, whereas the rest are private-sector workers. These figures represent about one-fourth and one-fifth of total public and modern private-sector urban employment, respectively.

Unions have recently become increasingly flexible. Reasons for this new flexibility appear to be related to past political mistakes (such as the relative failure of the last three general strikes called by unions, and the unions' opposition to reforms perceived by the general public as positive), and to a recognition of changing conditions that require their modernization.

Some signals of this new flexibility that are worth mentioning are:

- Willingness to discuss and adopt a new labor procedures law (Ley De Procedimientos Laborales), which would reduce to a large extent public-sector arbitrariness and power in the solution of collective labor conflicts;

- Meetings with private-sector organizations without government intervention, as if to suggest that government was the disturbing factor in previous conversations;

- Acceptance of a law for part-time workers (Ley de Trabajo a Tiempo Parcial) and the Ley de Maquila, instruments that exempt groups of workers and firms from job-security rights;

- Three agreements between CEDOC and the chambers of small industries (Camaras de Pequeños Industriales) in the provinces of Pichincha, Esmeraldas, and Manabí, which establish flexible arbitration mechanisms for dealing with labor conflicts, and unions accept that wages should evolve according to productivity and quality. As general and empty as these agreements may be, they open the door to a discussion of wider agreements in labor issues.

It is clear that unions are now willing to negotiate. The evidence should not be misinterpreted, however. Unions are not willing to drop labor conquests without anything in exchange. Even if union leaders recognize the negative effects of job-security rights on employment generation, union members perceive these same rights as an advantage gained over other groups in society. Union members have vested interests in the maintenance of job-security rights and, thus, impose limits to the bargaining capacity of union leaders.

From the point of view of unions, job-security rights guarantee income security, even if they do so at the cost of reducing the number of jobs available. As discussed in the previous section, job-security rights have side effects that hurt workers, in the sense that firms are not willing to train and retain workers. This point should be made clear to unions, jointly with the fact that forms of attaining income security (other than job security) could be devised with less negative side effects on workers' welfare. Unemployment insurance could provide income security, without the negative effects on employment generation that job-security rights have under the present system.

MAJOR FINDINGS AND CONCLUSIONS

On Labor Regulations

- Labor regulations have important effects on labor costs: 1) mandatory fringe benefits add 95 percent to the cost-per-hour of an unskilled worker earning minimum wages; and 2) mandatory severance payments increase the expected cost of hiring a new unskilled, minimum-wage worker by an additional 26 percent. This cost becomes larger the more unstable the firm's output.

- Severance payments also have important effects on employers' and employees' incentives: 1) firms have no incentives to retain and to train workers, because the longer the worker's tenure or the higher the worker's salary, the higher the severance payments due if the firm has to lay off workers; and 2) workers have to be paid wages much higher than normal market wages to remain with the firm. Otherwise, the worker will try to be fired, collect his/her severance payment, and begin the circle again at another firm.

- The GOE apparently understands the negative effects of the labor law and has taken some steps to make more flexible the labor market through the enactment of the *Ley de Maquila* and the *Ley de Contratación Laboral a Tiempo Parcial*. Both laws act toward a de-facto elimination of job stability (*estabilidad laboral*) and mandatory severance payments.

- Unions have also demonstrated an increased flexibility in working toward compromises in issues related to labor regulations, both through acceptance of GOE actions, and through the opening of a dialogue with private-sector organizations.

On Micro- and Small-scale Enterprises

- MSEs fulfill an important role in employment generation in Ecuador. More than 60 percent of total urban employment is generated in enterprises with less than 20 employees. Excluding self-employment, slightly more than half of the total number of jobs was generated in firms with between 2 and 19 employees.

- MSEs tend not to comply with labor regulations by being invisible and informal, evading the weak public enforcement mechanisms. Thus, labor market regulations are enforced in larger firms for 40 percent of the nation's employees. In itself, this is an indication that something is wrong with the labor law.

- Most MSEs find their competitive advantage in lower labor costs, resulting from evasion of minimum wages, mandatory fringe benefits, industrial security, and severance payments. For them, evading labor and fiscal regulations is a question of survival: they could not under any conceivable condition meet the costs imposed by existing regulations.

- However, for the most successful MSEs, labor regulations are an important obstacle that hurts their growth and employment-generation possibilities. All other things equal, the cost of generating an additional job and becoming visible and formal is three times higher for a MSE than for a big firm. Larger firms become liable to two additional sets of costs: 1) mandatory fringe benefits that must be paid to all workers, not just the newly hired; and 2) severance payments that must be paid when the firm adjusts to market down-turns by firing employees.

POTENTIAL POLICY CHANGES

An assessment of the effect of potential policy changes on MSEs must recognize as a starting point that for most firms within this category labor regulations are not a binding constraint. In fact, most MSEs find their main competitive advantage in the evasion of labor regulations. As shown above, informal and invisible firms face labor costs that are one-third those of modern enterprises. Furthermore, given the reasonable assumption that MSEs are more labor-intensive than bigger firms, the cost increase due to formalization and visibility is unaffordable for most MSEs.

However, there is a group of MSEs for which labor regulations constitute the most important constraint to growth. The creation of an additional job costs three times as much for a MSE that becomes visible than for an already visible bigger firm. This poses enormous problems for the growth of the more successful MSEs. The most successful are generally larger, have more complex organizational and technical layouts, face better market opportunities, are located in sectors where they can successfully compete and integrate with bigger firms in complex production chains (often including subcontracting with bigger firms), and employ wage workers. Regarding their potential for creation of productive jobs, they are the ones that can provide meaningful employment opportunities by growing into modern firms. But, they are quantitatively a minor part of the whole MSE universe, and are not the poorest (or the neediest) within the sector.

Programs for supporting MSEs generally tend to neglect this group of successful firms, because they are not considered to need credit or technical assistance. They are not the poorest within the poor, and their credit needs are generally well above the maximum limits established in MSEs' supporting programs. Their needs are generally related to larger production runs, the introduction of quality-control methods, and an adequate normalization of production. Because they are often informal subcontractors to bigger firms, these processes are crucial to obtain customer's satisfaction and, therefore, more stable markets.

These successful MSEs stand to win the most with elimination of job-security rights and more-flexible labor regulations related to fringe benefits. Because they operate in a more unstable market environment than bigger firms, lower cost, of adjustment to adverse market conditions is crucial for them. To facilitate their "graduation" to formal firms, they need the creation of a legal environment where contractual agreements between employers and employees could allow a more gradual enforcement of fringe benefits regulations. This process will not only benefit them, but also society at large, by the beneficial effects of improved competition in the domestic market.

The Actors

The GOE seems firmly embarked on a policy reform course. The reforms of the tax and tariff laws have been already enacted by Congress, thus making it difficult for the political opposition to impose a reversal. However, problems remain. They range from lack of action regarding public sector inefficiencies (particularly in the social services area) to mismanagement of public employees' collective contracts. Enactment of the law for part-time work and the *Ley de Maquila* indicate clearly the government's willingness to introduce changes in labor regulations.

Unions are showing a surprising willingness to open new areas of dialogue and to be more flexible in bargaining on wage and working conditions, including rights to job security and severance payments. However, unions are not willing to give up their historic conquests. Unions can still obstruct progress if pushed too far. This message should be clearly stated to the private sector. Unions' increased pragmatism opens an opportunity for meaningful discussions about the effects of the present labor regulations, and about ways to change it toward a less-damaging system.

The private sector was somewhat hurt by the recessionary effects of last year's adjustment (1989), and is not developing an aggressive search for alternatives in issues related to labor regulations.

Recent GOE actions are seen as a crack in the door that opens the possibility of new reforms, but so far no proposals have been advanced by the private sector.

A Proposal for Policy Reform

Elimination of job-security rights and implementation of an unemployment insurance system

Repeal of the labor law seems neither possible nor desirable. The GOE and the unions have made it clear that the problem is job security *(estabilidad laboral)* and not the labor law. Labor costs of less than $0.50/hour for an unskilled worker, however, do not appear to be an unsurmountable obstacle to international competitiveness.

Elimination of job-security rights, in turn, would have beneficial effects in that they would reduce the damaging impact of macro-economic instability on employment generation. However, something must be given in exchange to workers who will lose what they perceive as their acquired rights to job security. The crucial issue here is to distinguish between job security and income security. The present system provides income security by making it very expensive to fire a worker. The cost, of course, is that laid-off workers can't find new jobs in the modern sector and end up employed in the informal sector at much lower wages.

The alternative is to provide income security through unemployment insurance. Laid off workers would have access to a significative fraction of their previous incomes (income security). As contributions to unemployment insurance are proportional to a firm's payroll, the firm has no direct cost increase associated with the firing of a worker. To have access to unemployment insurance, workers should have contributed to social security for at least 52 weeks in the last 24 months. The system would provide workers with a significant fraction of their last wage for a period of six months following their dismissal. Employed workers would thus acquire income security. The unemployment insurance system should be funded by employers, employees, and government contributions.

Policy Recommendation

The GOE, unions, and the private sector should be encouraged to establish an unemployment-insurance system funded by employers' and employees' contributions. Once it is fully implemented, the job-security clause in the Labor Code should be repealed and firms' severance payments to workers should be replaced by unemployment insurance payments.

Establishment of a temporary exemption from payment of mandatory fringe benefits for MSEs

The most successful MSEs operate in a very unstable and uncertain market environment, and would benefit the most from the elimination of the cost of job-security rights. However, given the large costs of growth they face, additional incentives should be given to bring them into the formal system. This will not only benefit them, but society at large, by the beneficial effects of increased competition in the domestic market.

Overall exemption from labor regulations for MSEs would give incentives for bigger firms to splinter their operations and thus earn the exemption. This is undesirable for economic and political reasons. MSEs are non de-facto exempt, however, given the weakness of the enforcement apparatus. A window of opportunity for self-selected MSEs should be opened to permit them to enter the formal system. Identifiable advantages would be access to improved credit, marketing, training, and information systems, and avoidance of legal sanctions that would go with their greater visibility.

This could be achieved through a temporary exemption from mandatory fringe benefits for MSEs, to be phased out over a period of four years. This exemption should be designed to allow contractual arrangements between employers and employees to move within a band whose floor would be the minimum-wage regulations as a minimum, and whose ceiling would be the presently mandated fringe benefits.

Policy Recommendation

The GOE should enact a temporary exemption from payment of mandatory fringe benefits for MSEs. The exemption should be phased out over a period of four years from a firm's registration, and should leave contractual arrangements between employees and employers free to move within a band defined by the minimum wage and the mandatory fringe benefits established by law.

Implementation of a program of specialized credit plus technical and organizational assistance for the more successful MSEs

The more successful MSEs have needs for credit and technical assistance different from MSEs at large. Quality control, normalization of production, and creation of ability to manage larger production runs are among them. Some NGOs operating in Ecuador, like INSOTEC and Fundación Carvajal, have developed a wealth of experience about economic and effective ways to support the growth of MSEs through holistic approaches. These programs need refinements to cater effectively to the needs of MSEs. The GOE and international donor agencies should support NGO programs directed at the more-successful MSEs. These programs should be separated from more generic credit-plus-technical-assistance programs oriented toward MSEs at large.

The new *Maquila* regime could boost growth opportunities for some of these successful MSEs. Private-sector firms should be encouraged to develop subcontracting arrangements with MSEs. A specialized program would improve the probability of success and client satisfaction of these subcontracting arrangements. This program should offer credit at market interest rates, and beneficiaries should be charged for technical and organizational assistance provided to them.

Policy Recommendation

The GOE and private-sector organizations should be encouraged to create a special program of credit plus technical and organizational assistance to cater to the needs of the more successful MSEs that could grow and evolve into modern-sector firms.

ANNEX 1

A DESCRIPTION OF KEY LABOR LAW DISPOSITIONS

REGULATIONS THAT AFFECT HIRING AND WORKING CONDITIONS

In general, all dispositions of the Labor Code are to be interpreted in the way more favorable to employees (art. 7 CT), and minimum standards set by the Labor Code are not subject to individual contracting (art. 4 CT). These two traits are common to all social legislation, as they recognize the inequality of economic power between employers and employees.

Labor Contract

Contracts are deemed to have a minimum term of a year (art. 14), and a probation term can be established up to a maximum of 90 days. However, no more than 15 percent of workers can be held on probation, except for a period of 6 months for new firms (art. 15 CT). When a collective contract have been signed, individual contracts are subject to its terms and conditions (art. 22 CT).

Length of the Work Day

Maximum length of work-day is 8 hours, with a maximum of 40 weekly hours (art. 46 CT). Night shift begins at 7 p.m. and ends at 6 a.m., and is paid at a premium of 25 percent over normal salary (art. 48 CT). Over-time is limited to 4 hours in a day and to 12 in a week. They are to be paid at a premium of 50 percent, except in the case of night-shift where the premium is of 100 percent over normal wage. In the case of piece work, there is the same premium for work performed above 8 hours daily (art. 54 CT).

Working Conditions

Internal regulations of working conditions must be approved by the Labor Ministry, and can be modified by petition of more than 50 percent of workers (art. 63 CT).

If a worker is assigned to an occupation different from the one he/she is performing it is to be considered indirect firing, even if it does not reduce his/her earnings (art 193 CT).

Employing a worker in an occupation different from the one he/she was previously performing it is to be considered indirect firing, even if it does not reduces his/her earnings (art 193 CT).

Collective Contracts

When a firm has more than 15 employees, and a union or a *Comité de Empresa* exists, it is obliged to sign a collective contract (art. 227 CT) establishing the conditions of individual labor contracts (art. 228 CT). If more than a union exists, the firm has to sign a collective contract with each one (art. 229 CT). However, collective contracts may be temporally suspended with Labor Ministry authorization in case of input or energy shortages (art. 236 CT).

When a collective contract has been signed by two thirds of employees and employers in an industry or province, it will become binding for all employers in the industry or province (art. 247 CT).

Unions

Unions can be established in any establishment employing more than 15 workers (art. 436 CT). (Note: the law establishes the limit of workers for establishments within a province, not for a firm nationally). An alternative form of union is the *Comité de Empresa* with practically the same attributes as unions (art. 455 CT).

Individual Conflicts

All individual conflicts are to be solved by civil law regulations.

Collective Conflicts

Workers have the right to strike (art. 463 CT) and employers that of lock-out (art. 513 CT). In both cases, actions are to be authorized by the *Inspector del Trabajo*.

All collective conflicts are to be submitted to the *Comité de Conciliación y Arbitraje*, an organism composed of two representatives each for employers and workers, and one government representative. In case no conciliation is attained, the *Tribunales Superiores de Conciliación y Arbitraje* (of the same composition) are the superior instance, whose resolutions cannot be appealed.

Lock-outs can only be declared by special causes that affect a firm to the point of danger of forced liquidation, or by lack of foreign sourced inputs. During lock-out, collective contracts are suspended and workers do not receive remuneration.

REGULATIONS THAT AFFECT WAGES AND VARIABLE LABOR COSTS

Salary Definition

For the calculation of all indemnizations, salary will encompass all payments in money, services, or kind that the worker receives — including over-time, profit participation, or any other normal remuneration —, but it will exclude all supplementary payments — *decimotercer, decimocuarto and decimoquinto sueldo, utilidades, bonificacion complementaria*, and *bonificacion por transporte* — established by the law (art. 94 CT).

Minimum wages

The government is empowered to set minimum wages for different economic activities (art. 120 CT), and the *Consejo Nacional de Salarios* (CNS, composed of government, firms and unions representatives) is the technical/consultive organism in charge of the task (art. 121 CT). There are annual revision of minimum wages, in case minimum wages are not revised they will be automatically indexed by the CPI (art. 130 CT).

Differential wages for MSEs were set for the first time in 1979. A differential minimum wage for *artesanias* (handicrafts) is always set.

The CNS and the *Comisiones Sectoriales de Salarios Minimos* (CSSM) set minimum wages at a more detailed level by economic activity and occupation, these minimum wages being generally higher than the general ones. Out of 117 activities regulated by the CSSM, differential minimum wages for MSEs are set only in 52 sectors.

Thirteenth Salary

Before 12/24 of each year firms will pay each worker a sum equal to one twelfth of total yearly salary earned during last year (art 111 CT). This payment is non taxable (art 112 CT).

Fourteenth Salary

Before 9/15 of each year firms will pay each worker a sum equivalent to two minimum wages of the respective occupation (art. 113 CT).

Fifteenth Salary

During April each year firms will pay workers S/.50,000 (created by DS 3402/1979, increased by D 1066/89)).

Profit Sharing

Employers will pay to workers annually an amount equivalent to 15 percent of liquid profits. Of that amount, 10 percent of liquid profits will be given to workers on a per-capita basis, the other 5 percent will be given to workers according to number of dependents, up to a maximum of four minimum wages per dependent. If a union exists, the payment will be made through it (art. 96 CT). Artisans are exempted from this disposition (art. 101 CT)

If some money is left over, it will be deposited in an special Central Bank account, and 20 percent will be dedicated to environmental improvement, 30 percent to workers' training, 10 percent in child protection, and 40 percent in workers' housing programs. The money will be administered by the relevant Ministries.

Nontaxable Bonus

All workers will receive a non-taxable bonus of S/.12,000 annually in monthly payments (created by D 350/75, increased by D 1066/89).

Transportation Benefit

All workers earning less than two minimum wages will receive S/.3,200 monthly (created by D 2425/78, increased by D 1066/89).

Cost-of-Living Increases

All workers earning less than two minimum wages plus S/.2,500, will receive monthly the difference between their actual salary and that sum, up to a maximum of S/.2,500 (created by L 109/82, increased by D 1066/89).

Social Security Reserve Fund

All employers must deposit yearly at an special account in the *Instituto Ecuatoriano de los Seguros Sociales* (IESS) a sum equivalent to one monthly wage for all employees with tenure greater than a year (art. 198 CT).

After a period of four years these deposits become available to workers.

Social Security Contributions

Contributions to social security are established at 9.35 percent and 10.85 percent of monthly salary for employees and employers, respectively. This contribution cannot be substituted by payments to alternative insurance schemes.

SECAP Contribution

All employers must pay 0.5 percent of total monthly payroll to SECAP. This payments cannot be substituted by payments to alternative training institutions.

Vacations

Each worker has the right to receive 15 days (including non-working days) of holidays each year. After five years of tenure, workers are entitled to 1 additional day for each year of tenure in excess of five, up to a maximum of 15 additional days. (NOTE: this reduces the number of effective work-days in the year, thus increasing cost-per-day)

REGULATIONS THAT AFFECT TERMINATION COSTS

Just-Cause Firing

Employers can terminate the labor contract by disciplinary causes, for repeated absences of the employee, and for violations of industrial security by the employee (art. 171 CT). Causes for just-cause firing are taxatively established, and do not include a fall of demand to the firm. Just-cause firing must be qualified by the Labor Ministry authority, whose resolution can be appealed to the labor judges.

Pregnant women cannot be fired during pregnancy and for a period of 6 weeks after delivery (art. 154 CT). No worker can be fired when a union or *Comite de Empresa* is being organized (art. 448 CT).

Job Stability

Established with every wage rise decree since 1979, *estabilidad laboral* does not allow employers to terminate a labor contract except for just-cause. In the D 1006/89, workers with (a) 3 or more years of tenure cannot be fired for a period of 2 years, (b) less than 3 years of tenure cannot be fired for a period of 1 year.

Firing Notice *(deshaucio)*

Employers can terminate a contract by giving a 30 day notice (pink slip) in indefinite contracts (art. 184 CT). However, contracts cannot be terminated with notice before the first year (art. 186 CT). Fixed-term contracts are automatically renewed unless one part gives notice 30 days before the expiration date (art. 184 CT).

Employers cannot give firing notice within a period of 30 days to more than 2 employees in establishments with less than 20 workers, and to five in bigger establishments (art. 187 CT).

Severance Payments

In case of just-cause firing no indemnizations are due.

In case of firing with previous notice *(deshaucio)*, the employer will pay an amount equivalent to 25 percent of last monthly wage per year of worker's tenure in the firm (art. 185 CT). (Note: under *estabilidad laboral* it is forbidden to give firing notice)

In case of layoff without notice *(despido intempestivo)*, the employer will pay an indemnization of two months of wages to employees with up to 2 years of tenure, 4 months to employees with tenure between 2 and 5 years, of 6 months to employees with tenure between 6 and 20 years, and 12 months to employees with more than 20 years of tenure (art. 189 CT).

CHAPTER FOUR

TRADE POLICY AND REGULATORY ENVIRONMENT AND THE MICRO- AND SMALL-SCALE ENTERPRISE IN ECUADOR

by

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INTRODUCTION

Background

In the 1950s Ecuador embarked on an import-substitution policy designed to encourage local production of consumer goods then being imported with foreign exchange earned from agricultural exports, principally bananas. The laws and agreements promulgated over a period of some 30 or more years accomplished this end by creating protective tariff and nontariff barriers, exempting raw materials and capital goods from duties, granting tax holidays, and providing industrial development incentive agreements.

During the 1970s oil boom and the military government of Rodriquez Lara, the industrial development and protection policy was reenforced. Oil wealth made Ecuador internationally creditworthy, so private and public debt was accumulated to fund industrial and public projects. With this deluge of dollars and debt, the real exchange rate was allowed to become overvalued. This made foreign exchange underpriced in terms of *sucres* and imports, attractive, even with high tariffs. To maintain effective industrial protection, the use of nontariff barriers was broadened. This included the ultimate protection: denial of licenses to import goods competitive to those of protected industries.

With the collapse of oil prices and Ecuador's subsequent 1981-1982 financial crisis, a series of emergency fiscal and monetary reforms were embarked upon in the successive governments of Roldós/Hurtado, Febres Cordero, and Borja. Those with direct effect on trade included exchange control shifts ranging from a four-tiered system of controlled (*intervención*) and free rates. With the crisis, high and unpredictable inflation quickly became a reality. It is not an old predicament revisited, as Ecuador does not have the history of accelerated inflation of numerous other Latin American countries. Within the various exchange structures tested, the last three governments have also used macro- and mini-devaluations to deal with international trade exigencies.

Until the current government the policy and practice of import substitution has stood. While the previous government expressed keen interest in liberalizing trade policy, it was only with the start of the Borja presidency in August 1988 that a clearly outward-looking set of policies was promulgated to demarcate trade liberalization and supporting actions. These include:

- Agreement with the International Monetary Fund (IMF) and the World Bank on a range of financial and fiscal reforms conducive to the recuperation of economic health, consistent with trade liberalization;

- Liberalized tariff reform;

- Exchange rate pegged to inflation;

- Official support of exports of nontraditional products; and

- Dealing with trade-inhibiting factors rooted in labor law.

There is a widely expressed opinion in Ecuador that the two-year-old framework of *gradualismo* for the implementation of policy is a stalling tactic and that little additional concrete trade and fiscal reform will be accomplished by the time President Borja's term expires in August 1992. Those that doubt a strong government commitment to promoting liberalization of trade see policy reforms to date as:

- A sop to international institutions whose assistance is required by Ecuador; and

- A reflection of one wing of the cabinet.

Ecuador's debt of some $11 billion with its GNP of roughly the same amount stands as evidence of the country's need of support.

Speculations on the government's degree of commitment apart, promising major beginnings have been made in trade policy alteration:

- A Tariff Reform Bill has been enacted to gradually reduce duties and phase out nontariff restrictions and benefits over 30 months starting in March 1990. Tariff nomenclature is GATT-based; and

- The exchange rates have been consistently devalued.

Minister of Finance Jorge Gallardo has stated that the objective of the tariff reform is "...to have a rationalized duty structure which eliminates the existing over-protection of import substitution industries, [and] which permits reduction of the anti-export bias to the greatest possible degree...."[1]

No matter how purposefully these trade policy changes may be pursued the creation and growth of enterprise and trade will continue to be hobbled by the negative regulatory environment engendered by the pervasive red tape of the local and national bureaucracies in the areas of business and trade

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[1]Widely quoted in Ecuadorian press and television.

registrations, export, and import. These *trámites* (see examples of Annexes 1 and 2) are widely and consistently mentioned by private- and public-sector parties alike, as undermining broad access to enterprise and trade. Despite numerous proposals to the authorities for simplification and their promises of reform, they have not yet developed nor put into effect approaches that are both easy to use and easy to comply with financially. While this may be due in part to public-sector interests to control more than to facilitate, it is noteworthy that an Inter-Institutional Commission under the Junta Monetaria of the Central Bank has been carrying out research for two years on the rationalization and simplification of import and export procedures.

As this report is being prepared, the Iraq crisis has driven the price of oil well beyond the country's budget reference base of $16.25 per barrel. An evident opportunity has presented itself for the GOE to accelerate and then consolidate its liberalized trade reforms at the same time it reduces its debt burden and pursues other fiscal and monetary stabilizing polices on its agenda.

Purposes of This Report

The primary purposes of this report are to assess Ecuadorian trade policies as they relate positively, negatively, and neutrally to MSEs and to recommend related practical approaches that interested development agencies may take in support of this sector. The specific components under consideration will be regulatory environment, exchange rates, trade liberalization (reversing of import substitution policy), imports, and exports.

AN OVERVIEW

Regulatory Environment and Micro- and Small-scale Enterprises

MSEs are at a decided disadvantage to larger-scale industries in gaining entry to both national and international markets due to the time- and cash-consuming regulatory control for business registration, trade licensing, applications for credit, import licensing, and qualification to export. These *trámites*, already cited as detrimental to industry and commerce as a whole, weigh most heavily on the small enterprises which have neither the human nor material resources of the medium and large concerns to take on these tasks. Referring to Annex 1, an example of this is the S/.448,265 ($555) cash cost and 32-hour time investment to register a company. Annex 2 portrays the even more onerous 473-hour and S/353,000-cost annual investments required to simply remain in the formal sector. A majority of micro-enterprises would not be expected to "graduate" to the formal sector even if access were relatively open. Nevertheless, it is desirable, if only to stimulate trade and competition, that micro- and small-scale enterprises have the opportunity to enter the formal sector where they can more readily grow than in the informal sector.

As will be reviewed in their respective sections, import and export procedures are an even greater impediment to MSE participation in those trade areas. Much as the Central Bank's Inter-Institutional Committee has been constituted for the purpose of simplifying import/export procedures, it is vital that suitable committees be constituted to alter procedures and related costs so as to ease the way for MSEs in trade licensing, credit application, and company formation and maintenance situations. An "honest broker" intermediary should be sponsored by development agencies to represent the small business community by promoting the establishment of appropriate commissions at municipal and national levels and, indeed, to contribute substantively to these commissions' efforts.

The Instituto de Investigaciones Socio Económicas y Tecnológicas (INSOTEC) may be mentioned as a candidate to this intermediary position for their research in the field of *trámites*. Using an intermediary instead of Chambers of Commerce and trade associations avoids the friction that is more likely to develop if the directly interested parties negotiate head-on. Nonetheless, the intermediary would work closely with the Federación Nacional de las Pequeñas Industrias, Cámara de Pequeñas Industrias de Pichincha, Cámara de Pequeñas Industrias de Guayas, and other representatives of small enterprises directly effected by the regulatory environment.

As the various procedural items achieve negotiated rationalization and simplification, the intermediary should prepare and make available to intended users brief and simple information sheets.

Micro- and Small-scale Enterprise Participation in Manufacturing and Commerce

The informal, MSE participation in commerce and industry is not reliably documented. Nevertheless, existing information shows that 858,000 of the 2,209,000 urban economically active population work in micro-enterprises of six or less workers. The distribution of this 39 percent can be seen in Table 1.

Small enterprises, most of which are part of the formal sector, are more fully documented. Table 2 reveals relevant data on this segment's participation in the industrial sector.

TABLE 1

URBAN INFORMAL SECTOR
ECONOMICALLY ACTIVE POPULATION (1988)

CITY	EAP	Percent
Quito	162,146	18.9
Guayaquil	248,741	29.0
Cuenca	36,492	4.3
Intermediate cities	160,833	18.7
Small towns	249,682	29.1

Source: Encuesta Nacional Urbana de Hogares Sobre Empleo, Salud y Vivienda, 1988, Ministry of Labor and Human Resources.

The industrial protection policy has weakened the micro- and small-scale enterprise aspirants. Showering advantages on medium and large industry, such as duty exemptions for material inputs and capital goods, has placed smaller enterprises at an initial competitive disadvantage. At the next level, it has castigated the MSEs by forcing them to use locally made intermediary inputs of an often inferior quality, low quality being a by-product of protection from competition. Overall, the protectionist policies have attracted human and material resources away from activities to which they would have been naturally attracted (that is, those with comparative advantage), and has resulted in inefficient industry at the top and confined industry and commerce at the bottom. As well as subjecting local markets to generally inferior manufactured goods, the potential to participate in world markets has been stunted by the lack of quality and production efficiency engendered by the import substitution policies. Likewise, since these policies have militated against free attraction to participation in economic activities based on comparative advantage, products

TABLE 2

SMALL INDUSTRY PERCENTAGE
PARTICIPATION IN THE MANUFACTURING SECTOR

	1981	1982	1985	1988	1989
Establishments	67.6	67.2	67.1	68.8	68.9
# Employed	21.3	20.5	20.9	21.9	68.9
Remuneration	14.9	14.6	14.1	13.7	13.6
Production	16.7	16.5	15.6	17.0	17.0
Value Added	14.7	14.4	14.7	19.1	19.9

Source: F. Fernández, INSOTEC, Condiciones de Entorno de las Pequeñas Empresas en el Ecuador.

that might have been internationally attractive have either not come into being or are crippled for competitive purposes.

Opportunities for MSEs to prosper in commerce (wholesale and retail trade) are also curtailed by the limitation of competition produced by blocking imports. The end result is that Ecuador has opted to "protect" its home market of 10.5 million mostly poor people. It has sacrificed export opportunities that may have prospered without such interference. Ironically, two-thirds of the import bill is for intermediate inputs and capital goods for these protected industries.

Although the industrial protection policies have been a severe handicap to small enterprise, they have managed nonetheless to fractionally enhance their numerical position within the manufacturing sector as indicated in Table 2. This can be credited largely to small enterprise being forced into competitive form just to survive, while protected industry has, by definition, not needed to fight so hard.

The micro-enterprise profile and baseline research, which is part of this overall study, is a positive step toward clearly establishing the place this sector occupies in Ecuador's trade and industry make-up. It is important to extrapolate data to quantify and qualify the micro- and small-scale enterprise position vis-à-vis all commerce and all industry. Further studies are to be encouraged. It will then be possible to have reliable, supportive, and guiding information on micro- and small-scale enterprise sector growth and participation during the anticipated dismantling of trade-inhibiting import substitution policies.

Legislation on Micro- and Small-scale Industry Development

Seventy-five pieces of legislation and decrees ostensibly favoring small and crafts industry have been promulgated in the past 25 years.[2] Nevertheless, this patchwork of development bills has not yielded a stable or robust micro- and small-scale industrial subsector. The small enterprise development acts have failed to bear significant results because they operate within a policy framework of industrial protection, and have not put forward integrated approaches to overcoming key constraints facing small and micro enterprise; namely:

[2]Fernando Fernández, *Condiciones de Entorno de las Pequeñas Empresas en el Ecuador*, Anexo 1.

External Constraints	Internal Constraints
Import Substitution Policies	Financial
Regulatory *Trámites* and Controls	Production and Technical
Credit Access	Management Know-how
Local Inputs	Market Knowledge and Access
Imported Inputs	
Export Access	
Information	

Furthermore, overcoming the *trámites* to qualify for benefits under the various programs has usually defeated the intended beneficiaries. As might be expected, they are particularly those on the lower end of economic and human resources.

The promulgation of this plethora of bills over the years has tried to correct the damage done to MSEs by the dominant import substitution policy. But the distortions are so great and pervasive that band-aids are no cure. The greatest micro- and small-scale enterprise development support to be recommended is that the government follow through on the implementation of trade liberalization policies already legislated.

Trade Liberalization and the Micro- and Small-scale Enterprise

The implementation of programmed trade liberalization will lessen and eventually remove industrial protection. These industries will lose low- and no-duty status on raw materials and capital goods. High tariffs and import prohibitions status on competing goods will be altered. Exchange rate distortions should disappear. To survive, let alone thrive, industry will then have to overcome the inefficiency and inadequate quality previously fostered by protective policy.

Preparations for liberalization should include industry-by-industry studies to project survival potential and the needs in terms of technical, management, and labor reforms, as well as financial support. On a case-by-case basis, the GOE may decide to give loans and even subsidies to those industries which have either the survival potential of adequate comparative advantage or are deemed to be strategic. However, the assistance must be transparent; that is, not through economy-distorting and perception-blurring policy approaches as has been the case for decades.

It is in the interest of small enterprise, too, that viable currently protected industry be assisted into a free trade era because:

- This will defuse their opposition to liberalization;
- The continuation of the availability of local raw materials is advantageous; and
- The economy will not be excessively jarred by business failures and resulting job losses.

Outward-looking trade policies will be an overall boon to commerce and industry by encouraging the flow of human and material resources to economic activities where they will be used to best advantage, rather than to those which attract them through artificial advantages. Micro- and small-scale enterprise growth, in particular, will be stimulated by:

- Availability of better-quality domestic raw materials and other inputs;
- Availability of needed imported inputs at competitive prices;
- Cost and quality potential to compete in international trade; and
- A vibrant domestic commercial marketplace based on open competition instead of closed markets.

Small producers will want to target:

- Segments or "niche" sections of markets (examples: school uniforms, snack foods);
- Markets for which intensive labor input is a comparative advantage (examples: tile production, basket making); and
- Rural and farm markets (examples: tannery, halters and withers for draft animals).

New opportunities for MSEs to supply components to manufacturers will develop based on the availability of quality and cost-effective domestic and imported inputs. MSEs in the commercial sector will benefit particularly by the internationalization of the Ecuadorian marketplace and the resultant marketing opportunities afforded by the existence of a great variety of products.

Although Ecuador's outward-looking trade policies will bring new and expanded domestic and export prospects for micro- and small-scale business people, it is necessary that they become educated in what these opportunities will be, how to participate in them, and how to profit from them. For this, preparation in quality control, market selection, credit sourcing, and information sourcing will be needed.

EXCHANGE RATES

Controlled and Free Rates

Ecuador operates under a two-tiered[3] system of exchange rates; free market and *intervención*, or controlled market. The first is based on supply and demand, while the controlled rates are imposed by the Central Bank of Ecuador. All export transactions must be registered. Exporters turn over foreign currency receipts and receive sucres at the reigning controlled market "buy" rate. Approved imports are paid for in sucres at the Bank's controlled foreign currency "sell" rates. Essentially all other foreign currency transactions occur at the free market rates, with no ceiling on the amounts which may be exchanged.

The difference between the controlled market and free market "buy" rates has been as little as 4.9 percent (first quarter 1990) and as great as 47.8 percent (FY 1988) during the period 1985 through June, 1990. The corresponding "sell" rate comparison shows 2 percent at the narrowest gap (second quarter 1989) and 41.2 percent as the widest (1988). The second quarter 1990 "buy" controlled market versus free market difference was 11.4 percent while the "sell" comparison was 11 percent. Narrow spreads are advantageous to exporters, putting them closer to the larger amount of sucres they would have received through the free market. Wide gaps are advantageous to importers, in effect giving them a discount on the purchase of dollars.

TABLE 3

CONTROLLED/FREE RATES BUY/SELL COMPARISONS

	Buy Rates(1) Controlled	Buy Rates(1) Free	Percent Difference	Sell Rates(2) Controlled	Sell Rates(2) Free	Percent Difference
1985	95.00	115.52	21.6	96.50	116.29	20.5
1986	122.05	148.08	21.3	123.42	148.51	20.3
1987	169.97	193.23	13.7	170.97	193.80	13.4
1988	294.34	435.03	47.8	308.88	436.19	41.1
1989	510.91	567.24	11.0	542.09	568.18	4.8
1990						
1st Qtr.	669.72	702.74	4.9	683.11	706.51	3.4
2nd Qtr.	727.50	810.69	11.4	742.15	823.63	11.0

(1) Controlled "buy" equals sucres per dollar paid to exporters by Central Bank.
(2) Controlled "sell" equals sucres charged per dollar by Central Bank for approved imports.

Source: Banco Central del Ecuador, Información Estadística Mensual, No. 1,637 of 15 July 1990.

In the same period (1985 through second quarter 1990), the spread between the controlled market's buy and sell rates varied from less than 1 percent (1987) to as much as 10.5 percent (first quarter 1989). As the spread widens and the controlled sell rate approaches the free market sell rate, the importers' dollar "discount" vis-à-vis the free rate becomes less.

[3]A third rate, the "official market," exists currently at S/.390 to the dollar. It is used only for Central Bank accounting purposes.

Those who export more than they import are discriminated against by the controlled rate system. Those who import more than they export are favored by the system. The latter are typically the import substitution industries. As well as having their raw materials and capital goods imports effectively subsidized by net exporters under the existing foreign exchange system, they are given tariff advantages and exemptions on the importation of these raw materials and capital goods.

By contrast, small-scale enterprises usually rely on local purchase of needed imported materials because they are effectively blocked from importing (see following section). These raw materials normally enter Ecuador under duty-paid conditions because they were not destined for protected industry. They may also have paid the higher free rate of exchange for lack of importation approval from the Central Bank. Given the difficulties to import, competition is usually light; so importers can often charge big mark-ups. Furthermore, small industry buys small quantities, so it receives little or no trade discount. The net effect is that small industry cannot compete with protected large industry on the costs of inputs, nor can its production compete in international markets if imported inputs are used. Small industry is thus encouraged to use local intermediary inputs (when they exist) which may lessen the quality of its products.

In policy dialogue with the GOE, international development institutions and agencies should encourage the movement toward a free market exchange rate system. On the way toward that goal, the Central Bank should be encouraged to narrow the spreads between the free and controlled rates to a minimum so as to reduce the pro-import substitution favoritism and to reduce the anti-export and anti-small enterprise biases. The notable widening of the spreads in the second quarter of 1990 is troubling. As well as providing exporters a reduced sucre return per dollar, Central Bank shifts in exchange rates create an unstable base for exporters to fix their dollar FOB prices. To protect themselves, they must set prices high, with the result that they may price themselves out of markets when compounded with the already reduced return on dollars at the mandatory controlled rate.

Relationship Between the Inflation and Exchange Rates

Ecuador's accelerated inflation rates are cause for grave concern. With regard to trade policy, the relationship of inflation and exchange rates is also critical. While importers are happy to see exchange rate devaluations lag behind the inflation rate (if they are granted import licenses, that is), the volume of exports is endangered by this condition. By way of example, if a 10 percent inflation for a given period is not compensated by a corresponding alteration in the exchange rate (that is, 10 percent more sucres per dollar paid in by the exporter), exporters must sacrifice from their profit margins, raise their dollar prices, or even take loses until the exchange rate catches up. Such a situation makes for very unfavorable conditions under which to price stably and competitively into export markets. Under a unified free market exchange regime this situation does not arise. The sucre return per dollar automatically adjusts through the market mechanism.

TABLE 4

COMPARISON OF INFLATION RATE AND EXCHANGE BUY RATE

Year/Month	INFLATION(*) Index	Change	CONTROLLED MARKET Sucres:$	Change
1986 Avg.	487.7(1)	23.0	122.05	28.5
1987 Avg.	627.7	29.5	169.97	39.3
1988 Avg.	993.2	58.2	294.34	73.2
1989 Avg.	1,744.4	75.6	510.91	73.6
1990 Jan.	2,121.2	3.7	650.73	4.1
Feb.	2,219.4	4.6	663.30	1.9
Mar.	2,312.3	4.2	695.14	4.8
Apr.	2,417.1	4.5	712.17	2.4
May	2,487.6	2.9	727.67	2.2
Jun.	2,550.9	2.5	742.83	2.1

(*)Based on Central Bank of Ecuador's weighted Consumer Price Index of food and beverages, housing, discretionary, and miscellaneous costs.
(1)Base Year May 1978-April 1979 = 100

Source: Extracted from exhibits in Central Bank of Ecuador, Información Estradística Mensual, Bulletin No. 1,673 of 15 July 1990.

From 1986 through June 1990 the consumer price index has increased 523 percent while the controlled rate of exchange has increased 612 percent from S/.122.05 to the dollar to 742.83 (see Table 5). Although the rate of devaluation has exceeded the rate of inflation for this period, yielding a real devaluation of 17 percent, catching up has been necessary to bring the controlled rate into a range where Ecuadorian exports, particularly nontraditional ones, can compete. It is argued, furthermore, that the existence of a free rate fixed by demand factors that is currently (August 1990) some 12 percent higher than the controlled one indicates that the sucre is overvalued by that percentage.

TABLE 5

COMPARISON OF INDUSTRIAL INFLATION RATE TO CONTROLLED EXCHANGE BUY RATE

Year	INDUSTRIAL INFLATION Index	Change	EXCHANGE RATE Sucres	Change
1986	579.5	28.7	122.05	28.5
1987	764.4	31.9	169.97	39.3
1988	1,343.0	75.7	294.34	73.2
1989	2,262.2	75.9	510.91	73.6

Source: Banco Central del Ecuador, Boletín Anuario, No. 12, 1989-1990.

While moving toward a unified exchange rate, within the GOE's fiscal and monetary policy to restrain inflation, it would help exporters maintain stable prices if devaluations are frequent and do not trail far behind the inflation rate. For the first six months of 1990 the cumulative devaluation for the period lagged nearly five points behind the cumulative inflation. In the same period (see Table 3) the gap between the free and controlled "buy" rates has widened approximately six and a half points, also to the detriment of the exporter.

TARIFFS AND TRADE LIBERALIZATION

Tariff Reform Analysis[4]

The Tariff Reform introduced in March 1990 begins the reversal of the long term trade policy of import substitution which has resulted in production inefficiency, misallocation of resources vis-à-vis comparative advantages, and an anti-export bias.

The Reform encompasses several components:

- Use of a new tariff code (the GATT-compatible NANDINA);
- Application of new tariff schedules; and
- Removal or phasing out of nontariff controls, benefits, and vehicles including:
  - Duty exemptions,
  - Import authorizations,
  - Import prohibitions,
  - Export prohibitions,
  - Deposits to apply for import authorization,
  - Export quotas.

The Reform is scheduled to be completed in 30 months in three stages.

Stage One (until the end of 1990) includes:

- Imposition of the NANDINA nomenclature;
- Imposition of minimum and maximum duty levels (0-60 percent and 80 percent for automobiles, replacing 0-290 percent);
- Tariff rationalization, eliminating equivalents and similar items;
- Elimination of the 30 percent surcharge applied to List II items (luxury goods);

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[4]A detailed analysis is contained in "Reforma Estructural al Sistema Arancelario 1990" published by the Ministerio de Finanzas.

- Definition of products to be maintained on a special favored status list to lessen impact during transition period;

- Formulation of proposal for phasing out of nontariff restrictions starting early 1991; and

- Formulation of proposal for the modification of present duty exemptions. The objective is to reorient benefits to exports.

Stage Two (1991) encompasses:

- Elimination of Monetary Stabilization Surcharges (5 percent List IA, 8 percent List IB, and 15 percent List II);

- Redefinition of minimum and maximum duty levels;

- Publication of new exemptions policy;

- Publication of schedule to eliminate quantitative restrictions; and

- Definition of a transparent industrial protection structure.

Stage Three (1992) seeks:

- Continuation of adjustment toward a definitive tariff structure, without quantitative restrictions and with particular attention to export incentives.

The new tariff's duty percentages on individual items do not represent a huge departure from those existing, except in the case of construction materials. They still protect import-substituting industry. A study prepared by the International Commerce Department of the Ministry of Finance based on 276 items accounting for 63.7 percent of the effective (excluding duty-exempted) imports in 1988 showed that the 16.9 percent average duty applicable would have been 14.1 percent at the new rates. The more telling effects will come from the removal of the myriad of nontariff controls and privileges. For instance, the Ministry of Finance estimates that the various formulas of duty exemption privileges extended in 1988 reduced the potential Custom's income by 53 percent.[5] The burden of these privileges is supported by the sectors not participating in them.

The Tariff Reform Bill represents Ecuador's single greatest commitment to a positive economic future through a liberalized trade approach. It sets the foundation for a trade environment in which MSEs will be able to participate and thrive in a wider range of activities, including direct and indirect export. However, those whose interests lie in continued protection can be expected to resist its implementation. The danger lies in a hybrid policy, resulting in continued distortions that undermine meaningful reform. Supporting international institutions as well as the GOE are urged to insist on reform in an unadulterated form and with maximum dispatch.

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[5]Ministerio de Finanzas, "Reforma Estructural al Sistema Arancelario 1990," p. 27.

A great deal can be learned from Chilean trade liberalization. The GOE may study this example as a model to move from the still-protective new tariff schedule to a low, neutral level aiming to collect revenue but not to distort the economy nor impair export potential.

The Bush Administration's new "Enterprise for the Americas Initiative" is a positive development in that it addresses trade, investment, and debt burden problems with approaches to ease the participating countries into healthier economic situations based on open trade policies.

With simplification in procedures, ever-greater liberalization of tariffs and trade, simplification of entry as import and export participants, increased access to credit and to product and market information support, the MSEs in both commerce and manufacturing can expect greatly expanded growth opportunities in the 1990s.

IMPORTS

Inputs

Total Ecuadorian CIF imports in recent years have been:[6]

1980	$2.25 billion
1985	$1.77 billion
1986	$1.81 billion
1987	$2.16 billion
1988	$1.71 billion
1989	$1.85 billion

January-May 1990 imports ran approximately 1 percent behind the same period for the previous year.

The combined raw materials for industry and capital goods for industry as a percent of total value of imports are:

1980	55.0 percent
1985	62.6 percent
1986	62.6 percent
1987	59.8 percent
1988	64.5 percent
1989	66.2 percent
1990*	62.7 percent

* First five months

[6]Banco Central del Ecuador, *Información Estadística Mensual*, No. 1.637, p. 36.

These figures reflect the industrial protection with which Ecuador has operated for 35 years. For the first part of 1990, supplies for industry are at almost the same percentage as for 1986.

Official import statistics do not show size of enterprise, thus the degree of participation of micro- and small-scale industry in production input import is not known. However, indications (DAI 1990 micro-enterprise survey) show it to be trivial for micros. Interviews with small-producing companies point to direct importing being insignificant for small enterprise.

Import Procedures and Requirements

MSEs have been effectively barred from participating in imports by intrinsic constraints (see sector profile study) and by limitations imposed by trade policy regulations. These are the procedural *trámites* or red tape already alluded to as a great damper to MSE success. However irksome the *trámites*, the advance deposits (*depósitos previos*) provision would kill most MSE ability to import even when they are willing to wade through the red tape. The *depósitos previos* require the applicant to deposit up to 160 percent of the CIF value at no interest for 120 days before receiving permission to import.

The Ministry of Finance's Inter-Institutional Commission has been formulating simplified procedures for importing as well as exporting. The Instituto de Estratégias Agropecuarias (IDEA) has worked with the Commission to arrive at practical frameworks designed to allow a wide base of the private sector to have access to international trade.

Institutions interested in economic development should lend support to the Commission both directly and through IDEA, seeking the early acceptance of simplified procedures that will permit a general facilitation of the import side of international trade.

Import Duty Exemptions

The existing legal framework permits small industry to import raw materials under temporary duty exemption when the intent is to export the final product. However, this opportunity (Legal Decree No. 26 of 29 May 1986) has received scant use due to the bureaucratized procedural environment, lack of clear information, and the MSE sector constraints in finance, technology and production, management know-how and international market and marketing knowledge.

In August 1990, the Ley de Régimen de Maquila (Duty Free Zone Assembly) was passed. It too allows for the temporary importation of raw materials as well as any component of products to be exported. A limited number of secondary and tertiary cities are specified as targets for the Free Zone development of this activity.

The law permits piece work (*obra cierta*) and part-time employment under conditions not contemplated in the Labor Code. In effect, minimum wage and social security provisions must be respected but not severance payments clauses. Piece work and part-time employment are not restricted to the free zone cities.

These mechanisms may prove to be of value to small industrialists and possibly some micro-entrepreneurs when combined with simplified import procedures, and with support in financing, connections with overseas investors/contractors, and export marketing. This Free Zone production law may be useful as a bridge toward full integration into liberalized trade policy. That is, while tariffs are still high and nontariff controls still being utilized, the *maquila* and piece work laws may open a window for nontraditional, nonagricultural export potential. Nevertheless, in practical terms, this does not represent a policy or regulatory environment to assist small business oriented to domestic markets to acquire needed imported inputs easily at an internationally competitive price basis.

Contraband

Though not reliably quantified, fragmentary evidence indicates that contraband from Colombia and, to a lesser extent, Peru is substantial and that much of it is directly competitive with items produced by MSEs in Ecuador. Items such as food, clothing, apparel, farm implements, and household apparatus, are said to figure prominently among them. Out-going contraband of similar items exists, though no contraband balance of trade statistics are available.

The flows and content of contraband are related to:

- The monetary situation and policy of the moment of the three countries;
- Price controls; and
- Tariff and nontariff industrial protection frameworks.

In August 1990 the new President of Peru, Alberto Fujimori, instituted a massive devaluation while concurrently releasing price controls of basic commodities. In immediate response, Ecuadorian produce, much of it price-controlled, was attracted to the southern border where it could be sold for higher prices.

In liberalized trade circumstances without the distortions of import substitution policy (such as the need for price controls) and tiered exchange controls, the contraband question will die away and be replaced by trade based principally on comparative advantage. In fact, the Andean Pact Group (Colombia, Venezuela, Ecuador, Peru, and Bolivia) has a totally tariff-free market targeted for December of 1995. Annual legal imports from the Andean Pact partners by Ecuador generally account for about 5 to 6 percent of total, but statistics alone will show large increases once legal imports replace smuggled goods.

Real trade growth (import and export) among the Andean Pact countries may grow more than skeptics think. Their notion is that the countries have similar conditions and, therefore, do not complement each other in products. However, the same was said of the EEC countries which, are enjoying strong two-way trade combinations.

EXPORT AND EXPORT PROMOTION OF NONTRADITIONAL PRODUCTS

Export Policies Versus Export Environment

Ecuador has espoused a policy to promote the export of nontraditional products since the oil bust and start of the debt crisis in 1981/82. The traditional exports are banana, cacao, coffee, sugar, and crude oil. Success in promoting nontraditional exports has been most notable in the case of shrimp, the FOB value having gone from $71.8 million in 1980 to $387 million in 1988, surpassing banana exports.

However, on a constant dollar basis the overall nonoil exports have fallen since the late 1970s. In terms of 1979 dollars, the 1989 nonoil exports had a value 24.4 percent below those of 1979.[7] The lack of success can be attributed in great part to the anti-export bias of trade policy, the hostile regulatory environment for entry of new exporters, the lack of exchange rate incentives, finance and credit limitations, marketing uncertainties, and uncoordinated promotion policies and efforts by government agencies. In short, the over-riding import substitution framework was effective in suppressing growth of nontraditional exports.

The breakdown of 1989 exports by value was:

Classification	FOB US$000	% of Total
TOTAL	2,353.9	100.0
1. Traditional	572.3	24.3
2. Petroleum and Derivatives	1,147.4	48.7
3. Nontraditional	634.2	27.0
A. Primary	426.5	18.1
B. Industrial	207.7	8.8

It is within the industrial or processed product category that micro and small off-farm, off-wharf enterprise is located. Exports in this sector in recent years have been:

Year	FOB US$000	% Total Exports
1985	228.4	7.8
1986	231.2	10.6
1987	209.4	10.9
1988	226.2	10.3
1989	207.7	8.8

[7] Ministerio de Finanzas, "Reforma Estructural al Sistema Arancelario 1990," p. 14.

Figures do not exist which define the contribution of micro and small enterprises to this faltering export sector. In 1989, exports by industries in which MSEs strongly participate, however, were handicrafts and crafts products, $2.3 million; Panama hats, $7.1 million; and wood-crafted articles, $2.3 million, for a total of 5.6 percent of the sector's exports. (See Sector Profile section for more nontraditional export detail.)

As noted previously for internal trade and imports, the regulatory environment stymies the entry and growth of small, new participants in export. The lack of information on how to run these obstacle courses is an added constraint. Even where a guide through the maze does exist, micro- and small-scale enterprise may be effectively barred by the complication and costs of procedures. For instance, the Ministry of Industry and Commerce (MICIP) publishes a brochure entitled *Trámites y Requisitos Para Exportar*[8] which summarizes export requirements in 10 pages. Even though the bank guarantee requirement can now be circumvented, expenditure to overcome other red tape can easily outstrip gross profits on a small shipment. This is exacerbated by the obligation to change foreign exchange received at the controlled rate, currently about 12 percent under the free market rate.

As mentioned under the preceding Import section, an Inter-Institutional Commission under the Central Bank has been deliberating for two years on the rationalization leading to simplification of controls and procedures for export and import. Members of the Commission are the Central Bank, the Ministry of Commerce and Industry, the Ministry of Agriculture, and the Ministry of Finance, under which the Customs Department is situated. The efforts of this commission should be supported wholeheartedly. IDEA is doing supportive work with the commission and may benefit from inputs from parties interested in seeing Ecuador's international trade unfrozen and opened to wide participation.

Though some financing schemes do exist to stimulate exports, notably FOPINAR and Banco de Fomento, as discussed in detail in the accompanying chapter on credit, small would-be exporters find it difficult to get credit due to balance statement and guarantee requisites. Furthermore, loan approvals often take months.

Theoretically a great deal of support is given to established and incipient exporters who focus on nontraditional products. The Ministry of Finance admits that, "The existing system includes almost all known instruments in the subject: Tax Rebate Certificates, Draw-back, Temporary (raw materials) Admission, Free Zones, Promotional Funds. Nevertheless, it is of little relevance for fiscal reasons or lack of practicality in its execution."[9]

As has been stated in this report, when Ecuador has a transparent, liberalized trade policy with low, neutral duties, then straightforward efforts to promote exports will be adequate. Without the distortions, counter-measures such as tax rebates will not be required or even desirable.

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[8]Ministerio de Finanzas, "Procedures and Requisites to Export."

[9]Ministerio de Finanzas, "Reforma Estructural al Sistema Arancelario 1990," p. 28.

Freight Transport

GOE international transport policy protects its national air and ship lines. As in the case of industrial protection, such a policy leads to inefficiency and gaps in service. Maximization of exports is prejudiced when the protection level is such that it bars strong competition. While evidence shows that enough air freight competition is gradually being allowed to operate so as not to stifle exports from the Sierra, it cannot be said that exporters receive dependable service either from Ecuatoriana or Transnave. Small exporters in particular are endangered by inadequate service. In the case of perishables such as flowers, fruits, and vegetables, on-time shipment and good handling are crucial.

Direct service to a variety of destinations is important. Transfer and trans-shipment increase freight bills and, therefore, reduce competitiveness. As an example, a 40-foot container to Miami costs $1,800 whereas to Puerto Rico the cost goes up to $2,600, owing largely to trans-shipment. Likewise, air-freighting through Miami to other U.S. destinations runs up costs dramatically, whereas direct flights into other cities will allow for reduced freight bills and increased access to markets less saturated than Miami, New York, Los Angeles, and Chicago.

The GOE should be urged to open the doors for increased cargo-carrier competition to new destinations to promote export growth.

Export Support Entities

Although numerous export-promotion bodies exist in various of the ministries, little coordination is evident among them. A coordinating committee links them and the private sector, but it has not led an active life to date. With the advent of a simplified regulatory environment and trade liberalization, it becomes of higher priority that these agencies form an effective front and divide the responsibilities so that trade policy may be converted to a vigorous trade reality through the implementation of needed credit/finance, technical, management, market information, and marketing support.

SUMMARY OF RECOMMENDATIONS

Domestic Trade Environment

Development organizations are urged to support a concerted effort toward the institution of simplified and inexpensive procedures (*trámites*) in the areas of business incorporation or registration and yearly maintenance of status, trade licensing, and credit solicitation.

INSOTEC (Instituto de Investigaciones Socio-Económicas y Tecnológicas) has made recent studies in these areas and could be retained to coordinate reforms with the municipalities and institutions involved. INSOTEC can develop and propose simplified trámites that fulfill real public sector needs but are not so bureaucratic or expensive as to obstruct MSE participation. The various Chambers of Small Industry will be very supportive in recommending alterations.

International Trade Environment

El Comité Inter-Institucional of the Central Bank's Junta Monetaria has been working to simplify import and export procedures for two years. They have been supported in these efforts by the Instituto de Estratégias Agropecuarias (IDEA) which proposes approaches that will ease entry into international trade, thus widening the participant base.

IDEA could function as an "honest broker" in this arena. IDEA will draw upon suggestions from exporters and from the Federación de Exportadores (FEDEXPOR), which is promoting "Democratizaction of Export" to revitalize Ecuador's export potential in nontraditional products.

Exchange Rates

The current two-tiered exchange system obliging exporters to buy at the controlled rate is a distinct disincentive to export growth.

The controlled rate for importers, however, is basically a subsidy to the industries that receive more than 60 percent of the import licenses issued for raw materials and capital goods alone.

- Policy dialogue with the GOE should encourage a unified free-market exchange rate to support trade liberalization and a more favorable trade environment.
- While this goal of unified rates is pursued, the Central Bank should maintain a narrow spread between free and controlled rates.
- While the controlled rates still exist, the Central Bank should continue to peg the sucre close to the rate of inflation, with continuous devaluations, to encourage exports.

Trade Liberalization

- In keeping with the GOE's commitment to trade liberalization, international development and financial institutions should continue to support tariff and nontariff reforms. USAID/E has the framework of President Bush's Enterprise for the Americas Initiative to work within. The GOE should continue the progressive implementation of trade liberalization.
- International development agencies should support or sponsor studies of Ecuador's protected industries to determine their post-trade liberalization viability on a case-by-case basis. For those which have survival potential, transparent support programs may be projected and recommended.
- An in-depth review of the behavior of the various segments of the industrial and commercial sectors in one or more countries which have gone from import substitution to a liberal trade framework should be carried out. Chile would be the most relevant case to study.

Export Promotion

- Agencies interested in supporting export promotion could provide a valuable service by sponsoring studies of market prices and conditions in the U.S. for nontraditional agricultural and manufactured products, including calculations of FOB Ecuador prices needed to compete.

- Going beyond the above market study, projections of exports by types and destinations as trade liberalization takes effect in the 1990s would be another valuable input for planners, development agencies, and exporters alike.

- Within the context of qualifying and quantifying export projections, air and sea freight cargo estimates by destination should be supplied to the GOE with encouragement to prepare for expansion of fleets to meet anticipated demand.

- The GOE should reduce the level of protection for state air and maritime lines to encourage the participation of cargo carriers, better service, lower prices, and direct delivery to new destinations.

- Interested development agencies should examine the various existing Ecuadorian export promotion entities against actual institutional needs. The results and recommendations for an effective structuring and strengthening to meet exporters' needs could be provided to a revitalized Inter-Institutional Committee for Export Promotion.

- Qualifications to be an Ecuadorian Commercial Attache in one of the country's 20-odd embassies are more political than technical. This position should be based on technical qualifications so that export promotion may be effective in overseas markets.

ANNEX 1
NUMBER OF STEPS TO ESTABLISH A COMPANY AND OBTAIN A LOAN

Trámites Procesos	Constitución de Compañía	Obtención de un Crédito Pers. Jurid. (Nueva)	Obtención de un Crédito Pers. Natural (Nueva)	Obtención de un Crédito Pers. Jurid. (Existente)	Obtención de un Crédito Pers. Natur. (Existente)
EN EL INSTITUTO DE SEGURIDAD SOCIAL					
1. Número Patronal	*	*	*		
2. Cert. de actualidad pagos				*	*
EN EL MINISTERIO DE FINANZAS					
3. Reg. Unico de Contribuyente (RUC)	*	*	*		
4. Impuesto a la Renta		*	*	*	*
EN EL MINISTERIO DE INDUSTRIAS					
5. Calificación como PI		*	*	*	*
EN EL MUNICIPIO					
6. Patente Municipal		*	*		
7. Impuesto al Capital de giro	*			*	*
8. Impuesto Predial		*	*	*	*
EN LA ORGANIZACION GREMIAL					
9. Afiliación	*	*	*	*	*
10. Inspección	*	*	*		
EN EL REGISTRO DE LA PROPIEDAD					
11. Título de Propiedad		*	*	*	*
12. Certificado de Gravámenes		*	*	*	*

Trámites Procesos	**Constitución de Compañía**	**Obtención de un Crédito Pers. Jurid. (Nueva)**	**Obtención de un Crédito Pers. Natural (Nueva)**	**Obtención de un Crédito Pers. Jurid. (Existente)**	**Obtención de un Crédito Pers. Natur. (Existente)**
EN EL REGISTRO MERCANTIL					
13. Inscripción de escrituras	*	*			
14. Insc. nombramiento Rep. Legal	*	*			
15. Gravámenes de bienes mueble		*	*	*	*
16. Prenda de Comercio		*	*	*	*
EN LA SUPERINTENDENCIA DE COMPAÑIAS	*	*			
17. Reserva de nombre	*	*			
18. Aprobación de minuta	*	*			
19. Inspección de aportes	*	*			
20. Aprobación de escritura	*	*			
21. Publicación Escritura		*		*	
22. Aprobación de balances					
23. Autorización de giro en la cuenta de	*	*			
integración		*		*	
24. Cert. cumpl. en Notaria	*	*		*	
25. Escritura					

Trámites Procesos	Constitución de Compañía	Obtención de un Crédito Pers. Jurid. (Nueva)	Obtención de un Crédito Pers. Natural (Nueva)	Obtención de un Crédito Pers. Jurid. (Existente)	Obtención de un Crédito Pers. Natur. (Existente)
OTROS TRAMITES ADICIONALES					
26. Factura Proforma		*	*	*	
27. Apertura Cuenta Integración	*	*			*
28. Proyecto de inversión		*	*	*	*
29. Elaboración de planos		*	*	*	*
30. Autorización de Asamblea para contrata-		*		*	
ción crédito	*	*		*	
31. Convocatoria Junta de Socios	*	*			
32. Elaboración de minuta		*			
33. Aprobación de Estatutos por los socios					
EN EL MINISTERIO DE TRABAJO					
34. Inscripción contratos	*	*	*		
35. Retirar formulario		*		*	*
36. Trámite		*	*	*	*
NUMERO DE TRAMITES	19	35	17	20	15
COSTO PROMEDIO	S/.488.265,oo	S/.724.515,oo	S/.316.012,50	S/.259.250,oo	S/.256.250,oo

ANNEX 2

COSTOS LEGALES O TRIBUTARIOS DE PERMANENCIA EN EL SECTOR FORMAL DE LA ECONOMIA
Obligaciones impuestas por la Ley, que las pequeñas industrias deben cumplir a lo largo del año.

No.	OBLIGACIONES	RECURSOS	HORAS d/Tr.	Costo Unitario en sucres	Costo Total en sucres
	ENERO				
1	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte. Esto implica la elaboración de una nómina de pago completa y suficientemente clara que permita apreciar en forma individualista cada uno de los conceptos que se realicen. Fuente legal de la obligación: Código del Trabajo.	Secretaria o auxiliar	3	375,00	1.125,00
2	Aportes al IESS, elaboración y pago en ventanilla de planillas de aportes patronales y personajes. Se efectúa dentro de los 15 primeros días del mes. El envío de las planillas con retraso causa multas y recargos que son liquidados y cobrados por el IESS. Incluye la elaboración de planillas y comprobantes de descuentos para abonar a cuenta de créditos adeudados por los empleados y trabajadores de la empresa al IESS Fuente legal de la obligación: Ley de Seguro Social.	Secretaria o auxiliar Mensajero Transporte	2 3 -	375,00 375,00 100,00	750,00 1.125,00 100,00
3	Renovación del carnet de afiliación a la Cámara de la Pequeña Industria: Pago de cuotas.	Mensajero Transporte	3 -	375,00 100,00	1.125,00 100,00
4	Recalificación como Pequeña Industria. Trámite en las oficinas del Ministerio de Industrias. Debe realizarse en el primer trimestre de cada año. Fuente legal de la obligación: Ley de Fomento de la Pequeña Industria y Decreto Ejecutivo 1028. RO 248 de 13 de agosto de 1.985.	Contador Secretaria o auxiliar Mensajero Copias Transporte	3 2 6	1.125,00 375,00 375,00 300,00 200,00	3.375,00 750,00 2.250,00 300,00 200,00
5	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado Fuente legal: Ley de Régimen Tributario Interno.	Contador Secretaria Mensajero Transporte	8 4 3	1.125,00 375,00 375,00 100,00	9.000,00 1.500,00 1.125,00 100,00
6	Pago de la Patente Municipal. Fuente legal: Ley de Régimen Municipal.	Mensajero Transporte	3 -	375,00 100,00	1.125,00 100,00
	FEBRERO				
7	Preparación de roles y pago de remuneración, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
8	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales	Secretaria o auxiliar Mensajero Transporte	2 3 -	375,00 375,00 100,00	750,00 1.125,00 100,00
9	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador Secretaria Mensajero Transporte	8 4 3	1.125,00 375,00 375,00 100,00	9.000,00 1.500,00 1.125,00 100,00
10	Pago del Impuesto Predial Urbano Fuente legal: Ley de Régimen Municipal.	Mensajero Transporte	3	375,00 100,00	1.125,00 100,00

COSTOS LEGALES O TRIBUTARIOS DE PERMANENCIA EN EL SECTOR FORMAL DE LA ECONOMIA
Obligaciones impuestas por la Ley, que las pequeñas industrias deben cumplir a lo largo del año.

No.	OBLIGACIONES	RECURSOS	HORAS d/Tr.	Costo Unitario en sucres	Costo Total en sucres
	MARZO				
11	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
12	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
13	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
14	Declaración y pago de impuesto a la renta.	Gerente	8	3.125,00	25.000,00
		Contador	24	1.125,00	27.000,00
		Auxiliar	40	375,00	15.000,00
		Mensajero	4	375,00	1.500,00
		Transporte		100,00	100,00
	ABRIL				
15	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria	3	375,00	1.125,00
16	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
17	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
18	Llenada de formularios y pago del décimo quinto sueldo. El empleador debe consignar los datos referentes al 15 sueldo en los formularios elaborados por el Ministerio del Trabajo en los 15 días subsiguientes a la fecha del pago. Fuente de la obligación. Acdo. N.780 RO. 143 de 17 Dic. 81. y D.S. 3412. RO. 810: 10 Ab.79	Contador	1	1.125,00	1.125,00
		Secretaria	2	375,00	750,00
		Mensajero	6	375,00	2.250,00
19	Participación de utilidades. Elaboración de planillas y pago del 15% de las utilidades líquidas. El pago debe efectuarse hasta el 15 de abril de cada año y los formularios y nómina de pago presentarse en la Dirección General del Trabajo en el plazo de 15 días desde la fecha del pago. Pena de multa en caso de incumplimiento. Fuente legal: Código del Trabajo.	Contador	24	1.125,00	27.000,00
		Secretaria	3	375,00	1.125,00
		Mensajero	6	375,00	2.250,00
		Transporte		200,00	200,00
	MAYO				
20	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00

COSTOS LEGALES O TRIBUTARIOS DE PERMANENCIA EN EL SECTOR FORMAL DE LA ECONOMIA
Obligaciones impuestas por la Ley, que las pequeñas industrias deben cumplir a lo largo del año.

No. O B L I G A C I O N E S	RECURSOS	HORAS d/Tr.	Costo Unitario en sucres	Costo Total en sucres
21 Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
	Mensajero	3	375,00	1.125,00
	Transporte	-	100,00	100,00
22 Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
	Secretaria	4	375,00	1.125,00
	Mensajero	3	375,00	1.125,00
	Transporte		100,00	100,00
JUNIO				
23 Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
24 Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
	Mensajero	3	375,00	1.125,00
	Transporte	-	100,00	100,00
25 Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado.	Contador	8	1.125,00	9.000,00
	Secretaria	4	375,00	1.500,00
	Mensajero	3	375,00	1.125,00
	Transporte		100,00	100,00
JULIO				
26 Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
27 Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
	Mensajero	3	375,00	1.125,00
	Transporte	-	100,00	100,00
28 Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado.	Contador	2	1.125,00	9.000,00
	Secretaria	4	375,00	1.500,00
	Mensajero	3	375,00	1.125,00
	Transporte		100,00	100,00
29 Pago del primer anticipo de impuesto a la renta.	Contador	1	1.125,00	1.125,00
	Mensajero	3	375,00	1.125,00
	Transporte		100,00	100,00
AGOSTO				
30 Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria	3	375,00	1.125,00

COSTOS LEGALES O TRIBUTARIOS DE PERMANENCIA EN EL SECTOR FORMAL DE LA ECONOMIA
Obligaciones impuestas por la Ley, que las pequeñas industrias deben cumplir a lo largo del año.

No.	O B L I G A C I O N E S	RECURSOS	HORAS d/Tr.	Costo Unitario en sucres	Costo Total en sucres
31	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte	-	100,00	100,00
32	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
	SEPTIEMBRE				
33	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
34	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte	-	100,00	100,00
35	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
36	Preparación de roles y pago del décimo cuarto sueldo Las nóminas de pago deben presentarse en el Ministerio del Trabajo dentro de los 15 días posteriores al pago.	Contador	1	1.125,00	1.125,00
		Secretaria	2	375,00	750,00
		Mensajero	6	375,00	2.250,00
		Transporte		200,00	200,00
37	Pago del segundo anticipo de impuesto a la renta.	Contador	1	1.125,00	1.125,00
		Mensajero	3	375.00	1.125,00
		Transporte			
	OCTUBRE				
38	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
39	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte	-	100,00	100,00
40	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
	NOVIEMBRE				
41	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
42	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00

COSTOS LEGALES O TRIBUTARIOS DE PERMANENCIA EN EL SECTOR FORMAL DE LA ECONOMIA
Obligaciones impuestas por la Ley, que las pequeñas industrias deben cumplir a lo largo del año.

No.	O B L I G A C I O N E S	RECURSOS	HORAS d/Tr.	Costo Unitario en sucres	Costo Total en sucres
		Mensajero	3	375,00	1.125,00
		Transporte	-	100,00	100,00
43	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
44	Pago del tercer anticipo de impuesto a la renta	Contador	1	1.125,00	1.125,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
	DICIEMBRE				
45	Preparación de roles y pago de remuneraciones, compensación por costo de la vida, bonificación complementaria y compensación del transporte.	Secretaria o auxiliar	3	375,00	1.125,00
46	Aportes al IESS. Elaboración y pago en ventanilla de planillas de aportes patronales y personales.	Secretaria o auxiliar	2	375,00	750,00
		Mensajero	3	375,00	1.125,00
		Transporte	-	100,00	100,00
47	Revisión de documentos, preparación de formularios cálculo y pago del Impuesto al Valor Agregado	Contador	8	1.125,00	9.000,00
		Secretaria	4	375,00	1.500,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
48	Preparación de roles y pago del décimo quinto sueldo Las nóminas de pago deben presentarse en el Ministerio del Trabajo dentro de los 15 días posteriores al pago.	Contador	1	1.125,00	1.125,00
		Secretaria	2	375,00	750,00
		Mensajero	6	375,00	2.250,00
		Transporte		200,00	200,00
49	Preparación del formulario de encuesta del Instituto Nacional de Estadística y Censos	Gerente	8	3.125,00	25.000,00
		Contador	16	1.125,00	18.000,00
		Secretaria	3	375,00	1.125,00
		Mensajero	3	375,00	1.125,00
		Transporte		100,00	100,00
	S U M A N		474		$ 353.000,00

Fuente: Investigación INSOTEC
Elaboración propia

NOTA: No se incluyen gastos para pagar luz eléctrica, agua potable ni teléfonos porque se supone que el pequeño empresario debe utilizar el sistema de descuento de su cuenta corriente del valor correspondiente a las respectivas tasas. Mandarlas a pagar en ventanilla con el mensajero implica una mala asignación de re-cursos.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

The three previous chapters explored the Ecuadorian environment surrounding financial policy, labor policy, and trade policy. While the three areas merited separate exposition, they have common goals. All the policy alternatives aim at achievable economic development. All focus on MSEs in the belief that directly productive activities at the grass-roots level provide the nation's best hope for higher incomes and employment with equity.

Economic development is, of course, broader than a focus on small business. The conclusions and recommendations that follow, however, concentrate on that important segment of the economy. None of the recommendations suggest that small business should be favored at the expense of larger enterprise. But the preceding sections have emphasized that Ecuadorian policies have given excessive weight to larger industrial enterprises.

The goals of national development are ambitious, and some of the recommendations are correspondingly controversial. Ecuadorians' fatigue and frustration with slow growth in the 1980s has made the development dialogue more difficult and more polarized. At the same time, the worldwide movement toward freer trade, privatization, market solutions, and reliance on the democratic process is impressive. Ecuadorians have noted these historic changes occurring in other countries. They are determined not to be left behind. Accordingly, they ask themselves about lessons to be applied at home.

Given the history of Ecuadorian policy decisions, the recommendations carry with them a new spirit — a new approach — to the country's struggles for economic development. They center on a development strategy that:

- Is geographically decentralized rather than concentrated in one or two places;
- Stimulates initiatives below the middle of the income pyramid rather than relying on activities at the top;
- Recognizes the administrative weaknesses of the Ecuadorian public sector and accordingly spurs grass roots self-reliance on the private sector; and
- Seeks to reinforce efficient small-scale enterprises.

FINANCIAL POLICY

Although inflation has declined since 1988, its current levels remain high, both in absolute terms and relative to Ecuador's historical experience. The longer inflation persists, the more difficult it is to reduce it. Inflationary experience builds inflationary expectations. Yet productive investment would be greater in circumstances of price stability.

All participants in the development dialogue share the common goal of reducing inflation. None argue for its continuation or growth. Policies leading to lower inflation include reduction in the fiscal deficit, continued export promotion, and a reduction in subsidies to imports, and increases in supply associated with privatization of the biggest and least-efficient state enterprises.

Government-sponsored preferential interest rates for big business have been discontinued. Those firms can no longer take advantage of interest rates that, with the inflation, are negative in real terms. But interest rate policy for small firms remains an open question.

For example, MSEs have received loans whose concessional element is high by any standards. The needs of small business are recited as justification for these near-grants. Ecuadorians may indeed want to subsidize small business now, as they subsidized import-substituting industries for the past three decades. But the decision should be a conscious one, based on prospective costs.

Thus participants in the development dialogue should agree that real interest rates should be positive and market driven. The size of transfers to MSEs under government and international programs should be carefully calculated, so that all participants realize the extent to which new subsidies replace old ones.

The number of agencies involved in services, including financial services, for MSEs is so large as to confuse both the agencies and their would-be beneficiaries. Participants in the development dialogue should agree that the organized establishment of a single source of information about the multiple agencies would lower search costs and raise the effectiveness of each agency's programs.

The legal requirement that commercial banks devote 10 percent of their portfolios to social loans is unenforceable. An attractive alternative exists: the foundations tied to the banks Some are already in place; others are in formation. Participants in the development dialogue should support the potential that the foundations could serve many of the same purposes sought by legal provisions.

The numbers of small firms and their demands for credit, especially at subsidized rates, have not been fully recognized before this study. The new extensions of credit by multilateral lenders supplement previous programs. But the magnitude of legitimate needs should be realistically assessed by participants in the development dialogue. Failure to do so will lead to disappointment and needless fault finding.

While Ecuadorian credit policies toward MSEs clearly affect their ability to provide jobs, income, and productivity, an overall view shows the greater importance of macroeconomic policy more generally. In particular, when aggregate demand is growing, and when artificial barriers to supply have been reduced, the health of all firms, large and small, follows. All participants in the development dialogue should continue to encourage the refinement of economic policy along anti-inflationary, freely competitive, internationally open lines.

The uncertainties that the country faces externally include the price of oil. As this is written (December 1990), it seems likely that the world oil price will be much higher in the medium run than it has been at any time since the early 1980s. The danger is one of political economy. It would be easy for Ecuadorians and other oil producers (Mexico and Nigeria, for example) to imagine that the economic limitations of the recent past had been swept away. If Ecuador relaxes its efforts under the illusion that resource constraints have vanished, the country would be threatened by a repetition of the same problems that faced it in 1982 and 1983, and that have dominated the economy since then.

Some scholars have concluded that oil is a curse rather than a blessing for low-income countries. It has been too easy for politicians in oil-rich countries to convince themselves and their constituents that the presence of oil meant that scarcity was vanquished. While in principle, it's better to have natural resources than not to have them, in practice the observed results of oil's presence in Iran, Mexico, Venezuela, Nigeria — not to say, Ecuador — have been mixed at best. Thus participants in the development dialogue should marshall all their persuasiveness to help the GOE avoid a reversion toward the attitudes (and the spending that accompanied them) of the late 1970s, when high oil prices seemed to promise all.

LABOR POLICY

The Labor Code has been praised as a Latin American model of social welfare legislation. Its early passage (1938) and its broad provisions are worthy of attention. At the same time, its goals are now recognized to be expensive, stimulating formally constituted firms to economize on labor and use capital more intensively.

For smaller firms, less formal and less visible, the Code is more subtly discouraging. Among the smallest firms, its provisions are simply disregarded. For firms seeking to grow, a movement into visibility and formality has been shown (in Chapter Three) to be forbiddingly expensive.

The biggest disincentives to growth are associated with the requirements for severance payments to workers with three or more months of service. The regulations stimulate layoffs before workers have been on the job for three months. They undermine worker discipline and productivity among longer-service workers. They assume implicitly that employers are monopsonists while workers compete with one another for jobs. The assumptions are not in accord with the modern Ecuadorian economy.

Labor policy reform appears to be underway. Evidence about new openness to dialogue between employers, unions, workers, and government was cited. New laws dealing with part-time work, piece work, and in-bond factories (*maquiladoras*) are signs of the new flexibility.

The Labor Code is well entrenched. Workers and their representatives will not give up their *conquistas*. But the new atmosphere of flexibility may permit some bargaining. Workers will not surrender job-security rights (*estabilidad laboral*) and the associated severance payments without some offsetting benefit.

Participants in the development dialogue should recognize that one ambitious possibility is the replacement of job security rights by a national program of unemployment insurance. For small business, an insurance program would penalize growth less than the present regime of severance payments. And because a national program of unemployment insurance would have broader coverage, a greater proportion of workers would be among its supporters.

Such a program would be a bold and potentially costly step. The biggest barrier to its success would lie in the demands it would put on public sector administration. Nevertheless, given the disincentives to growth of MSEs apparent under present labor policies, a program of national unemployment insurance is worthy of the most careful scrutiny from influential participants in the policy dialogue.

Small firms are exempt de facto from provisions in the Labor Code. Their growth is hobbled, however, by their informality and invisibility. Their capacity for credit, training, and technical assistance would be greater if they were formally organized. Participants in the development dialogue should realize that small businesses could more readily graduate into formal status if MSEs could be temporarily exempt from the expensive set of fringe benefits mandated by the Labor Code. Gaining temporary exemption as a reward for becoming formal will appeal to the most efficient among the small firms.

Labor policy reform, like other reforms, proceeds more readily under conditions of macroeconomic stability and growth. Participants in the development dialogue should realize that reform is unlikely in recession. Growth provides a solvent for many social problems. A heightened appreciation for the benefits of a stable macroeconomic environment can thus pay big dividends.

TRADE POLICY

As a development strategy, import-substituting industrialization has been officially discarded in Ecuador. Vestiges remain, but tariff reform has pointed the economy toward greater openness. Continuing the process of trade liberalization should be encouraged.

Export promotion, especially of nontraditional exports, ranks high in most lists of priorities. Nevertheless, irksome and costly red-tape continues to characterize exports. The scarcity of foreign exchange leads Ecuadorian authorities to monitor transactions that generate it. Participants in the development dialogue agree that simplification of procedures would lower costs and give important incentives to exports, for large and small firms alike.

Procedures in other areas are unnecessarily expensive. Detailed studies by INSOTEC have quantified these costs in terms of time and money. Participants in the development dialogue may wish to take further advantage of INSOTEC's knowledge when seeking to further refine procedures.

Simplification in imports and exports has been on the agenda of the Junta Monetaria for two years. The support offered by IDEA should continue to be useful. The trade association Federación de Exportadores (FEDEXPOR) has also been active in seeking to promote nontraditional exports. Thus it is well informed about procedural barriers to them.

The exchange rate system now features two rates, a controlled rate and a free rate. Exporters are required to sell their foreign exchange receipts to the Central Bank at the controlled rate, while some but not all importers can buy at that rate. As elsewhere, the controlled rate returns fewer sucres per dollar to exporters than would the free rate. Correspondingly it sells sucres to importers at a more favorable rate (more dollars per sucre) than they could get in the free market. Thus, relative to the free rate, the controlled rate discourages exports and encourages imports.

Participants in the development dialogue should concur that in a country with balance of payments problems, policies that lead to lower exports and higher imports should be shunned. A unified exchange rate that approximates the free market rate can thus be recommended.

The two-tiered market for foreign exchange is particularly hard on MSEs. While these firms export little, many of them use imported inputs. However, because of their size and the red tape surrounding import permits, small firms usually buy their imported inputs at prices that reflect the free rate rather than the more favorable controlled rate. Thus their costs are higher than those of larger and favored importers, and their ability to compete in local markets are correspondingly impaired.

Inflation, as noted above, creates problems in exchange rate policy. The higher the inflation, the greater and more frequent must be devaluations. The Central Bank of Ecuador has followed the example of other Latin American countries in instituting a crawling peg, that is, a system of frequent mini-devaluations.

The policy question boils down to how fast the peg should crawl. Local manufacturers are favored by a low-cost dollar. They lobby in favor of overvaluation of the sucre. Mini-devaluations that are late and small cause overvaluation. But overvaluation leads inevitably to problems in the balance of payments.

Participants in the development dialogue agree that the crawling peg should be retained. The prospects for exchange rate movements should be carefully forecast by the monetary authorities. The forecasts reflect best guesses about international inflation differences, as well as nonfinancial factors affecting trade.

Those forecasts should control the speed of the mini-devaluations implicit in the crawling peg. To the extent possible, advance announcement should be made of the rate of future devaluation. This helps firms of all sizes to plan production and purchases of exports and imports with greater certainty. Because greater certainty allows managers to focus without distraction on real questions of output, growth, and employment, the economy benefits.

While macroeconomic events influence trade policy, policy formulation also relies on sectoral economic activity. The location within the economy of international comparative advantage depends on comparative costs. Recommendations that comparative costs be revealed solely by market processes are shallow. They ignore the benefits of information and the costs to small firms of generating it.

Participants in the development policy dialogue may wish to commission a short list of carefully selected studies of comparative costs in the most promising sectors. The results of these studies should be promulgated at the lowest possible price to all interested parties, including the smallest firms.

Similarly, small firms are unable to commission marketing surveys in the U.S. and other foreign markets to determine the most profitable export prospects. Participants in the policy dialogue should agree about the prospective productivity of such information, again, especially for the smallest firms.

OVERALL

It bears repeating that these policies are not isolated from one another. The monetary policy affecting inflation influences the need for devaluation. The foreign exchange rate policies that determine the price of imported inputs affect the costs of domestic goods. The cost of capital (the interest rate) influences the relative demand for capital and for labor. Labor policies that frustrate the graduation of small firms into a formal status stunt the possibilities for growth in employment and incomes. Failure of incomes to grow means that public policies are diverted from considerations of efficiency toward greater (and appropriate) concern with equity. In short, the notion of the economy as a circular flow is amply borne out by these observations.

This means, in turn, that no single action can solve Ecuador's development problems. The development of micro- and small-scale enterprise is likely to play an increasingly important role in the future. Participants in the development dialogue willing to make the effort to be informed about these alternatives are the most likely to influence outcomes positively and with cost-effectiveness.

APPENDIX A

LIST OF INTERVIEWS

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LIST OF INTERVIEWS

USAID/Ecuador (AID)
- Michael Deal
- Guillermo Jauregui
- Marco Peñaherrera

SIGMA 1
- David Franklin

AGROTECH
- Francisco Saenz

Banco Popular
- Patricio Puga

Banco Central del Ecuador
- Santiago Bayas
- Gonzalo Cordovez
- Roberto Pozo

Banco Nacional de Fomento
- Jorge Dávalos
- Luis Yacelga

Cámara de la Pequeña Industria Pichincha
- Hernán Carrera
- Tancredo Corral
- Ernesto Veintimilla

Central de Obreros y Campesinos (CEDOC)
- Ramiro Rosales

CETERIS
- Pablo Lucío Paredes

Circle Intercarga S.A.
- Eduardo Larrea
- Ricardo Obando
- Oswaldo Ruiz

Corporación Nacional de Apoyo a las Unidades Populares Económicas (CONAUPE)
- Patricio Martínez

Federación Nacional de la Pequeña Industria (FENAPI)
- César Rovalino

Federación Ecuatoriana de Industrias Exportadoras (FEDEXPORT)
Nelson Navas

Fondo de Promoción de Exportaciones (FOPEX)
Sonia de Merino

Fondo de Promoción para Pequeña Industria y Artesanía (FOPINAR)
Fabián Cerón
María Ríos

Fundación Banco Popular
Edison Pérez

Instituto Latinoamericano de Investigaciones Sociales (ILDIS)
Galo Chiriboga

Instituto de Estrategias Agropecuarias(IDEA)
Pablo de la Torre

Ministerio de Trabajo y Recursos Humanos
Ramiro González

Ministerio de Finanzas y Crédito Público
Luis René Vaca

Ministerio de Industrias, Comercio, e Integración
Ruth de Morales
Marcelo Ruiz
Hugo Mario Valarezo

Oficina de Exportaciones de Productos Artesanales (OCEPA)
Mercedes de Espinoza

Programa Nacional de Microempresa (UNEPROM)
Mauricio Córdova
Edison Echeverría

APPENDIX B

LIST OF ACRONYMS

AID	Agency for International Development
BCE	Banco Central de Ecuador (Central Bank of Ecuador)
BID	Banco Interamericano de Desarrollo (Inter-American Development Bank)
BNF	Banco Nacional de Fomento (National Development Bank)
BEDE	Banco Ecuatoriano de Desarrollo (Development Bank of Ecuador)
CAC	Cooperativas de Ahorro y Crédito
CACPES	Cooperativas de Ahorros y Créditos de la Pequeña Empresa
CAF	Corporación Andina de Fomento
CDs	Certificates of Deposit
CEDOC	Central Ecuatoriana de Organizaciones Clasistas
CEOSL	Confederación Ecuatoriana de Organizaciones Sindicales Libres
CFN	Corporación Financiera Nacional
COLAC	Confederación Latinoamericana de Cooperativas de Ahorro y Crédito (Latin American Confederation of Credit Unions)
CONAUPE	Corporación Nacional de Apoyo a las Unidades Populares Económicas
CONCAF	Confederación de Cooperativas de Alemania Federal
CNS	Consejo Nacional de Salarios
CSSM	Comisiones Sectoriales de Salarios Minimos
CT	Código del Trabajo
CTE	Confederación de Trabajadores del Ecuador
CUs	Credit unions
CUNA	Credit Union National Association) FECOAC (Ecuadorian National Federation of Credit Unions)
EAP	Economically active population
ECLA	Economic Commission for Latin America
EEC	European Economic Community
ENECEL	The state electric company
FECOAC	Federación Nacional de Cooperativas de Ahorro y Crédito del Ecuador
FEDEXPOR	Federación de Exportadores
FEE	Fundación Eugenio Espejo
FENAPI	Federación Nacional de Cámaras de Pequeños Industriales (National Association of Small Industry Associations)
FOPINAR	Fondo de la Pequeña Industria y Artesania
FUT	Frente Unitario de Trabajadores
GDP	Gross domestic product
GNP	Gross national product
GOE	Government of Equador
IDB	Inter-American Development Bank (see BID)
IDEA	Instituto de Estratégias Agropecuarias
IESS	Instituto Ecuadoriano de Seguro Social
INEM	Instituto Nacional de Empleo
IMF	International Monetary Fund

INSOTEC	Instituto de Investigaciones Socio-Económicas y Tecnológicas
ISI	Import substitution industrialization
LACs	Latin American countries
LDCs	Lesser-developed countries
MICIP	Ministerio de Industrias, Comercio, Integración y Pesca
MSEs	Micro- and Small-scale Enterprises
NGOs	Nongovernmental organizations
UNEPROM	Programa Nacional de Microempresas
UPEs	Unidades populares economicas
USAID	United States Agency for International Development
VAT	Value-added tax
VMPL	Value of marginal product of labor
WOCCU	World Council of Credit Unions

APPENDIX C

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