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REFLECTIONS ON THE RULE OF LAW AND DOLLARIZATION IN ECUADOR

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Johns Hopkins Institute for Applied Economics,
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Reflections on the Rule of Law and Dollarization in Ecuador[1]

by Steve H. Hanke

About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

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[1] This working paper will appear as a chapter in a book on dollarization in Ecuador to be published in September 2015 under the auspices of Universidad San Francisco de Quito. It is an amended version of "Money and the Rule of Law," which is a speech Steve H. Hanke presented on the occasion of receiving the Doctor of Arts Honoris Causa from Universidad San Francisco de Quito in 2003. It was subsequently published in *The Journal of Policy Reform* (2003).

the Universidad del Azuay in Cuenca, Ecuador. He has been awarded honorary doctorate degrees by the Bulgarian Academy of Sciences, the Universidad San Francisco de Quito, the Free University of Tbilisi, Istanbul Kültür University, and Varna Free University in honor of his scholarship on exchange-rate regimes. In 1998, he was named one of the twenty-five most influential people in the world by *World Trade Magazine*.

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Prof. Hanke's most recent books are *Zimbabwe: Hyperinflation to Growth* (2008) and *A Blueprint for a Safe, Sound Georgian Lari* (2010).

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Summary

The rule of law is defined and its implications in the monetary sphere are elaborated. When national monetary arrangements fail to comport with the rule of law, "dollarization" is desirable. That policy provides for more stable money and expectations about its future value. The salutary effects of Ecuador's "dollarization" program of 2000 are reviewed. In addition, a manifesto for economic reform in Ecuador is presented. Its elements are: financial integration, fiscal transparency and control, tax simplification and reform, supermajority voting, deregulation, and privatization.

The Rule of Law

What is the rule of law? The concept originated with the Greek Democracy. The premiere Hellenist Jacqueline de Romilly captured the essence of the idea by stating that "The Greeks, jealous of their independence, were always proud to proclaim their submission to Laws…. They demanded only that their city be ruled by its own Laws and not by a man. The Law was thus the basis and the guarantor of all their political life" (de Romilly 2001: 1).

That classical concept was ordered, classified, and elaborated on by Aristotle, and later the Romans lent practical aspects to the rule of law. Since then, it has been debated and adapted to modern times. For example, the American Constitution and Bill of Rights are short and clear and serve as a model for those who aspire to order, freedom, and the rule of law (Niskanen 2003). The Bill of Rights is notable because with one exception, the right to a trial by jury, it lists the rights of individuals against infringements by the state, rather than claims by individuals on goods and services to be provided by the state. The thrust of the American model, therefore, comports with the rule of law in the classical sense because the state is subjected to a fixed set of rules that delimit the scope of its coercive powers. Individuals and their property are protected from the arbitrary, *ad hoc* actions of the state and other individuals. In consequence, individuals can plan their activities within the confines of known, fixed "rules of the game." This allows people to pursue their personal ends, as long as their actions do not infringe on the broadly-defined property rights of their fellow citizens (Hayek 1944: 72-87).

Money and the Rule of Law

When properly applied, the rule of law guarantees freedoms in the economic, political, intellectual and moral spheres (Machlup 1970: 137). In the economic sphere, money constitutes an important element. Ludwig von Mises dealt at length with this issue in *The Theory of Money and Credit*, which was published originally in 1912:

> It is impossible to grasp the meaning of the idea of sound money if one does not realize that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments. Ideologically it belongs in the same class with political constitutions and bills of rights. The demand for constitutional guarantees and for bills of rights was a reaction against arbitrary rule and the non-observance of old customs by kings. The postulate of sound money was first brought up as a response to the princely practice of debasing the coinage. It was later carefully elaborated and perfected in the age which—through the experience of the American Continental Currency, the paper money of the French Revolution and the British Restriction period—had learned what a government can do to a nation's currency system (Mises 1971: 414).

Given Germany's experience with hyperinflation in the 1920s, it is not surprising that members of the Freiburg School (*Ordo*-liberals) elaborated on the money – rule of law nexus after the Second World War. For example, Walter Eucken, the founder of the Freiburg School, laid great stress on the rule of law and the primacy of a currency policy to safeguard the stability of the value of money (Sally 1998: 111-12).

When stripped of all its technicalities, the money – rule of law nexus is nothing more than a matter of property rights. If a government is in possession of a devaluation option, those who own money issued by the government face the prospect of having their property rights confiscated in an arbitrary, *ad hoc* manner via devaluations. Accordingly, governments that fail to protect the value of their money are guilty of not abiding by the rule of law.

Argentina's recent experience illustrates this point. Under the convertibility system, which was established on April 1, 1991, the government made an explicit redemption pledge. Each person who owned an Argentine peso was guaranteed the right to convert a peso for a U.S. dollar. To make this redemption pledge credible, the Convertibility Law required the government to hold U.S. dollar reserves at the central bank that, under most circumstances, would equal or exceed the value of the pesos the central bank had emitted. (I have discussed this at length in Hanke 1999c.) When the Convertibility Law was revoked by decree on January 6, 2002, the peso was devalued; the peso was allowed to float; and the redemption pledge was rendered null and void. In consequence, the government confiscated $17.8 billion of central bank reserves that had been the property of people who held pesos at the time of the devaluation (Hanke 2003).

What, then, is a country to do if it has a history of not adhering to the rule of law and is incapable of safeguarding the value of its domestic currency? The answer is obvious. It should abandon its domestic currency and replace it with a high-quality foreign currency. By doing so, a country will replace a weak (or nonexistent) domestic rule of law with a stronger foreign one. This, of course, will provide a better safeguard for the money used in the country that has abandoned its domestic currency. Not surprisingly, leaders from divergent schools of economic thought have embraced the "dollarization" solution for countries that are incapable of enforcing the rule of law in the monetary sphere. For example, Nobelists Milton Friedman (the leader of the Monetarist School), Robert Mundell (guru of the Supply-Side School) and Friedrich von Hayek (a pillar of the Austrian School) have all advocated "dollarization" in one form or another (Friedman 1973, Mundell 1973, and Hayek 1999b).

That said, a few words of caution are in order. The intersection of the rule of law with the coin of the realm implies a monetary rule, which allows people to form, with a reasonable degree of certainty, their expectations about the value of money. There are, therefore, a variety of monetary rules that, as a matter of principle, satisfy the rule of law criterion. When, however, national monetary arrangements fail to produce stable money and expectations about its future value, those national arrangements fail to comport with the rule of law. In these cases, "dollarization" advances the rule of law and is desirable because it stabilizes expectations.

Dollarization in Ecuador

Ecuador represents a prime example of a country that was incapable of imposing the rule of law and safeguarding the value of its currency, the sucre. The Banco Central del Ecuador was established in 1927, with a sucre-U.S. dollar exchange rate of 5. Until the 1980s, the central bank periodically devalued the sucre against the dollar, violating the rule of law. In 1982, the central bank began to exercise its devaluation option with abandon. From 1982 until 2000, the sucre was devalued against the dollar each year (Schuler 2002). The sucre traded at 6,825 per dollar at the end of 1998, and by the end of 1999 the sucre-dollar rate was 20,243. During the first week of January 2000, the sucre rate soared to 28,000 per dollar.

In the case of Ecuador, the inability of the government to abide by the rule of law is, in part, a consequence of traditions and moral beliefs. Ecuadorian politics have traditionally been dominated by elites (interest groups) that are uninhibited in their predatory and parochial demands on the state (Eifert, Gelb, and Tallroth 2002). With the lack of virtually any moral inhibitions, special interest legislation has been the order of the day. For example, during the rout of the sucre in 1999, laws were passed allowing bankers to make loans to themselves. In addition, state guarantees for bank deposits were introduced. These proved to be a deadly cocktail, one that allowed for massive looting of the banking system's deposit base (Akerlof and Romei 1993). This, as well as the collapsing sucre, enraged most Ecuadorians.

With the rule of law (and the sucre) in shambles, President Mahuad announced on January 9, 2000 that Ecuador would abandon the sucre and officially dollarize the economy. The positive confidence shock was immediate. On January 11—even before a dollarization law had been enacted—the central bank lowered the rediscount rate from 200 percent a year to 20 percent (Schuler 2002). But this newfound ray of hope was threatening to some, and during a 24-hour period (January 21-22), a *coup d'etat* ensued. While the Mahuad government was toppled, the coup was a bungled affair and the former Vice President Gustavo Noboa assumed the Presidency. He honored Mahuad's dollarization pledge. On February 29, the Congress passed the so-called *Ley Trolebus*, which contained dollarization provisions. It became law on March 13, and after a transition period in which the dollar replaced the sucre, Ecuador became the world's most populous dollarized country on September 13.[2]

With much the same enthusiasm as Ecuador's coup plotters and the rigidity of a dogmatic cleric, the critics of dollarization condemned it as something akin to voodoo economics. My sometime collaborator and a leading dollarization expert Kurt Schuler has compiled a list of some of the condemnations. A small, but representative, sample follows:

International Monetary Fund

- "Dollarization was not, I must be frank, the kind of policy we would have recommended at this stage to Ecuador. But in these circumstances we are not ideological or systematical in what we do. They have decided that. Now our role is to do everything we can do to help them manage it." –Michel Camdessus (Reuters newswire, January 17, 2000)
- "Dollarization 'isn't very adequate' under the country's current situation, [IMF managing director Michel] Camdessus said at a press conference during the Third Western Hemisphere Finance Ministers Summit." –(Dow Jones newswire, February 3, 2000)
- Dollarization in Ecuador is "one of the riskiest operations we have been involved in." –Unnamed "international finance official" (*The Economist,* April 1, 2000)

Banco Central del Ecuador

- "The authorities also consider that dollarization and convertibility are not viable schemes at the current moment." (BCE Statement, January 5, 2000)

[2] For a recent account of events leading up to dollarization in Ecuador, including the *dramatis personæ*, see "The Dollarizers" by Tristana Santos (Santos 2015).

- "Conditions to dollarize the economy do not yet exist." –Virginia Fierro, manager of the BCE (*New York Times,* January 12, 2000)

Investment Banks

- "The problem is, the Ecuadorian economy doesn't have the kind of fundamentals needed to successfully complete dollarization." –Federico Kaune, senior economist, Goldman Sachs (*Washington Post*, January 11, 2000)

Economic Commentators

- "Now its [Ecuador's] government has swung to the other extreme and is trying to restore confidence in the currency by abolishing it. Observers say this could work if it is accompanied by extensive domestic reform—which is a bit like saying that you can kill someone with witchcraft it you also give him plenty of arsenic." –Paul Krugman (*New York Times*, January 19, 2000)

These dire predictions proved to be baseless, but when it comes to commentary on sound-money currency reforms, they are commonplace (Hanke 2002b, 2003). The course of Ecuador's economy has followed the one set by the initial positive confidence shock that ensued after President Mahuad announced his intention to dollarize on January 9, 2000. Even the most cursory examination of these data confirms yet again the dictum of Karl Schiller, West Germany's minister of finance (1966-72): "Stability might not be everything, but without stability, everything is nothing" (Marsh 1992: 30).

Dollarization's Detractors

In spite of the fact that post-dollarization results have confounded the critics, dollarization's detractors still abound. Many academic economists favor monetary nationalism (Helleiner 2003: 186-217). They embrace the idea of a central bank and a domestic currency for each country and expound on the alleged shortcomings of monetary unification via the substitution of a foreign currency for a domestic currency.

Hayek warned in 1937 that the budding central banking fad, if it continued, would lead to currency chaos and the spread of banking crises (Hayek 1999a). His forebodings were justified. In 1940, there were 40 central banks and, as of 2003, 162 dot the globe. As Hayek anticipated, currency and banking crises engulf the international financial system with ever-increasing strength and frequency.

The major arguments of the monetary nationalists are manifestly invalid. They are inconsistent with empirical evidence and well-established propositions of elementary economics. The empirical evidence supporting this conclusion has been compiled and is readily available (Schuler 1996 and Hanke 2002a), and so is a concise critique of the analytical case against dollarization (Dornbusch 2001).

A critical evaluation of the academic literature is not possible here. However, a summary of Dornbusch's critique merits comment. First, in most emerging market countries, the so-called national pride that accompanies a domestic currency is little more than a political slogan. (For a contrary perspective, see: Cohen 1998: 35-39.) Indeed, most national currencies are a source of national embarrassment and anxiety. This explains why so many countries are unofficially dollarized (Hanke 2000). Second, the seigniorage losses from abolishing a domestic currency, while real, are more than offset by the reduction in interest rates and reductions in debt service costs that accompany monetary unification. Third, the loss of monetary policy levers with dollarization is real, but this is a benefit, not a cost. Furthermore, even in the case of a credible emerging-market central bank, the loss of monetary policy discretion is of little practical importance. After all, how many emerging-market central banks could prudently cut interest rates to levels below those in New York or Frankfurt? The fourth item concerns the loss of a lender of last resort after dollarization. This is nonsense. With dollarization, the lender of last resort exists in the form of credit from the fiscal authorities, the local banking system or the international capital markets. The lender of last resort, with dollarization, forces good market-based credit to be substituted for bad central bank credit. Lastly, without a domestic currency, the fiscal authority will have to stand on its own two feet. True. But by imposing a hard budget constraint, dollarization encourages fiscal prudence. This is a "good," not a "bad," outcome.

In addition to foreign academics, various Ecuadorian groups have, at various times, voiced opposition to dollarization. Many do so for ideological or opportunistic political reasons. One of the loudest voices of dissent has come from CONAIE, a group that represents indigenous Ecuadorians. Their claims are not only ill-founded, but contrary to the interests of the indigenous population in Ecuador. If they and other minorities are ever to attain equal rights in Ecuador—which they claim not to possess, but to desire—it will be on the back of the rule of law. Since dollarization has replaced a weak rule of law in the monetary sphere with a stronger one, the indigenous peoples—as well as all other Ecuadorians—should be shouting from the rooftops with joy.

Ecuador's exporters have complained about dollarization, too. They argue that an "overvalued" dollar has killed Ecuador's export sector. To put it politely, their argument is suspect. Even in the face of slow global growth, Ecuador's exports were higher in 2002 than when dollarization was introduced. Moreover, exports for the January-July 2003 period were up by 16.8 percent compared to the same period in 2002. Baseless whining by exporters is, of course, nothing new. Even though Argentine exports increased in every full year after the peso was linked to the dollar under the convertibility system—except 1999, when Brazil suffered a currency crisis—Argentine exporters unjustifiably complained about an "overvalued" peso (Hanke 2003).

So much for the exporters' casual empiricism. The *economic* argument that Ecuador's exchange rate parity with the U.S. dollar is "overvalued" is simply a result of faulty calculation. Economists calculate real effective exchange rates between currencies by comparing the relative movements of prices for tradable goods and services in each country. Accordingly, to make the correct calculation, producer price indices (sometimes called wholesale price indices) should be employed (Hanke 2003).

In 2003, I made my own calculation of Ecuador's real effective exchange rate using producer price indices in Ecuador and the United States. Ecuador's real effective exchange rate has appreciated by a mere 2.7 percent vis-à-vis that of the U.S. from December 2000 to July 2003. This appreciation represents the actual change in the terms of trade available to exporters. It is clearly not very big. Until exporters get their facts straight, they should not be taken seriously.

In addition, exporters should be reminded of a little history. The exercise of the devaluation option has been the centerpiece of central bank policy in most Latin American countries for decades. In consequence, crises and instability have ensued, and interest rates and the cost of capital have been sky high. Accordingly, modernization and competitiveness have been handicapped and real wages have remained relatively low. With dollarization, stability is established, competitiveness improves and real wages rise because the cost of capital is lower than it is with a junk domestic currency. Dollarization is, therefore, a tonic for both capitalists and their employees.

The cacophonous dissent against dollarization does appear in the press. Indeed, it often crowds out facts and reason. As a currency reform veteran, I have witnessed some truly amazing accounts of currency reforms in which I had detailed, first-hand knowledge. Tales have been spun by the press with threads of disinformation, half-truths and untruths (Hanke 2002b). In consequence, I have come to appreciate George Orwell's observation, which he made after recovering from most of his leftist deliriums: "Early in life I had noticed that no event is ever correctly reported in a newspaper, but in Spain, for the first time, I saw newspaper reports which did not bear any relation to the facts, not even the relationship which is implied in an ordinary lie" (Orwell 1968: 256).

That said, I do realize that no policy can be sustained without the support of public opinion and that the press has an enormous influence on the public's beliefs (Mises 1966: 863-64 and Hayek 1999b: 132). As a result, it is of utmost importance to set the record straight.

Ecuador's Current State of Economic Affairs

Dollarization has provided Ecuador with a positive confidence shock, stability and generally good economic results. But successive governments have failed to capitalize fully on the good news. All marketing professionals know that sales campaigns cannot be mounted without either a unique selling proposition (Reeves 1970) or a great brand image (Ogilvy 1985). With the adoption of the dollar, Ecuador was handed both on a silver platter. Accordingly, it could have launched an extraordinary campaign to promote Ecuador.

The Noboa government missed that golden opportunity. That government's ineptitude recalls the Duke of Wellington's characterization of Sir Hew Dalrymple's blunders in Portugal. The Duke wrote in 1808 that "The General has no plan, or even the idea of a plan, nor do I believe he knows the meaning of the word plan" (Rathbone 1984).

Even worse, the government allowed itself to be entangled in never-ending squabbles with the International Monetary Fund over what amounts to little more than small change, in the broad scheme of things. The result has been a classic marketing disaster, with the economic news coming out of Ecuador being dominated by accounts of the IMF pointing an accusatory finger at Ecuador. While this image of an aggressive prosecutor badgering an accused criminal sells newspapers, it is a public relations nightmare for the one who stands accused.

Even with the benefit of a home-grown dollarization project, Ecuador has failed to learn the golden rule of reform: successful reforms are created locally from the bottom-up. They are not imposed by international organizations from the top-down (Röpke 1959 and Powelson 1994: 327-41). Indeed, all the major economic liberalizations in the past forty years have followed that formula for success and have done so under very different political regimes: Chile (undemocratic military government), Britain (democratic, right of center), China (undemocratic, Communist Party), New Zealand (democratic, left of center), and the United States (democratic, right of center). In all cases, reforms were home-grown, bottom-up affairs, with the IMF and other international organizations nowhere to be found.

What, then, is the current state of economic affairs in Ecuador? In a word, they are terrible. Even though the rule of law has been embraced in the monetary sphere, it has been ignored elsewhere. Not surprisingly, the *2014 Index of Economic Freedom* categorizes Ecuador's economy as "mostly unfree." It ranks a lowly 159 out of 178 (Miller, Kim, Holmes 2014). Even by Latin American standards, Ecuador is at the bottom of the heap. Only Venezuela, Haiti, Suriname and Cuba are lower.

An Economic Freedom Manifesto

Ecuador's economic freedom ranking convincingly shows that liberalism, or neoliberalism as they term it today, has not been applied in Ecuador. This is unfortunate because economic freedom is the engine that drives sustained economic growth. Indeed, GNP per capita is quite sensitive to changes in economic freedom, measured by a variety of indices. For example, a 10 percent increase in economic freedom can be expected to produce an increase in GNP per capita of 7.4 to 13.6 percent. Accordingly, it is not surprising to observe that the level of economic freedom explains 56 to 75 percent of the variation in GNP per capita across countries (Hanke and Walters 1997 and Berggren 2003).

By not following the precepts of the rule of law, Ecuador is badly governed, and its economy is over-regulated and inflexible. To change this sad state of affairs and build on the foundation laid by "dollarization," Ecuador should embark on a deep reform program. The following manifesto sketches its elements.

Financial integration. With dollarization, Ecuador entered a unified currency zone with the United States. Ecuador's financial system is still not unified with the United States and the rest of the world, however. As of 2003, it only had four major banks, and for all practical purposes, they are not integrated into the international capital markets. Ecuador cannot, therefore, avail itself of the full benefits of dollarization. Ecuador should follow the lead of Panama and change its banking laws and regulations to facilitate financial integration.

Panama was dollarized in 1904, but financial integration did not occur until much later. To integrate its banking system into the world's financial markets, Panama changed its banking laws and regulations in 1970. As a result, international banks were attracted. The growth of Panama's banking system attests to the fact that the 1970 banking reforms allowed Panama to take advantage of the trends in globalization and free flow of capital. The banking sector is now over 50 times larger than it was in 1970.

Over two thirds of the banking system's assets are accounted for by banks that hold general licenses. These banks, which came into existence after the banking reform of 1970, can operate both offshore and in the domestic markets. Among other things, the banks with general licenses can do business with the Panamanian "international" banks that engage exclusively in offshore operations. Panama's dollarized monetary system eliminates its exchange rate risks and the possibility of a currency crisis vis-à-vis the U.S. dollar. And the possibility of banking crises is largely mitigated because Panama's banking system is integrated into the international financial system.

The functioning of the banks that hold general licenses provides the key to understanding how the system as a whole functions smoothly. When these banks' portfolios are in equilibrium, they are indifferent at the margin between deploying their liquidity (creating or withdrawing credit) in the domestic market or internationally. As the liquidity (credit-creating potential) in these banks changes, they evaluate the risk-adjusted rates of return in the domestic and international markets and adjust their portfolios accordingly. Excess liquidity is deployed domestically if domestic risk-adjusted returns exceed those in the international market, and internationally if the international risk-adjusted returns exceed those in the domestic market. This process is thrown into reverse when liquidity deficits arise (Moreno-Villalaz 1999). In consequence, the brutal adjustment mechanism of the sort described by David Hume is avoided. Indeed, departures from zero in the current account are smoothly facilitated by short-term capital flows (Kindleberger 1981).

The adjustment of banks' portfolios is the mechanism that allows for a smooth flow of liquidity (and credit) into and out of the banking system (and the economy). In short, excesses or deficits of liquidity in the system are rapidly eliminated because banks are indifferent as to whether they will deploy liquidity in the domestic or international markets. Panama is just a small pond connected by its banking system to a huge international ocean of liquidity. When risk-adjusted rates of return in Panama exceed those overseas, Panama draws from the international ocean of liquidity, and when the returns overseas exceed those in Panama, Panama adds liquidity (credit) to the ocean abroad. To continue the analogy, Panama's banking system acts like the Panama Canal to keep the water levels in two bodies of water in equilibrium. Not surprisingly, with this high degree of financial integration the level of credit and deposits in Panama are uncorrelated.

The results of Panama's dollarized money system and internationally integrated banking system have been outstanding, when compared to other emerging market countries.

- Panama's GDP growth rates have been relatively high and their volatility relatively low. This is rather remarkable, when you consider that Panama is a classic dual economy. On the one hand, the services sector (banking) is export-oriented, capital intensive, highly productive, generates little employment and is largely free of government interference. On the other hand, the agricultural and manufacturing

sectors are stagnant, highly regulated and subsidized, inefficient, labor intensive and uncompetitive.
- Interest rates have mirrored world market rates, adjusted for transaction costs and risk.
- Inflation rates have been somewhat lower than those in the U.S.
- Panama's real exchange rate has been very stable and on a slightly depreciating trend vis-à-vis that of the U.S.
- Panama's system, which operates without a central bank lender of last resort, has proven to be extremely resilient. Indeed, it weathered a major political crisis between Panama and the United States in 1988 and made a strong comeback by early 2000.

Fiscal transparency and control. Ecuador's fiscal operations are notoriously opaque and incomplete. Accordingly, there is little fiscal control and accountability. To put its fiscal house in order, Ecuador should adopt laws that mirror New Zealand's Fiscal Responsibility Act of 1994 (Richardson 1995: 234-43). After all, secrecy is for losers (Moynihan 1998: 1).

Such a fiscal reform would require Ecuador to publish a national set of accounts, which would include a balance sheet of its assets and liabilities and an accrual-based annual operating statement of income and expenses. These financial statements would be required to meet International Accounting Standards and they would be subject to an independent audit.[3]

Just what is an accrual-based operating statement? At present, accounts in Ecuador are kept on a crude cash basis. Revenues and expenditures are recorded when cash is received or paid out. With accrual accounting, spending and revenues are recorded when they are incurred, regardless of when the money actually changes hands. Accrual accounting gives a much more accurate picture of the realities and avoids many financial tricks that politicians can play with cash accounting. For example, under cash accounting, politicians can promise pensions for future retirees, but since no money is paid until people retire, there are no budgeted costs under cash accounting until the pensions are paid. With accrual accounting, the promises to pay future pensions would appear in the government's accounts when the promises for future obligations are made. Under accrual accounting, the government cannot distort the magnitude of its spending obligations.

Tax simplification and reform. Ecuador should simplify the tax system and introduce a unified flat tax rate for personal and corporate income, with the unified rate set at between 10 and 15 percent. This would improve incentives to work, save and invest. In addition, it would facilitate better tax administration, improve tax compliance, reduce the time necessary to comply with the tax code and increase revenues generated by income taxes.

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[3] The word "audit" brings to mind an interesting anecdote that illustrates politicians' aversion to the mention of that five-letter word:

> Hayek once joked as a young man that he would someday like to be president of the Austrian *Nationalbank*, and while he was in Freiburg during the 1960s, he apparently had the chance. "I was asked by the then right-hand side chancellor of Austria, after he had vainly asked Machlup, whether I would be willing to take over the presidency of the national bank, [to] which I assented on one condition, 'If I can engage one of the great international accounting firms to check out the nationalized industries.' That was the end of the conversation! (Ebenstein 2001: 255)

Supermajority voting. For important fiscal decisions, supermajority voting should be established in Ecuador. Many countries require supermajority voting for important decisions. Such a voting rule protects the "minority" from the potential tyranny of a simple "majority." A supermajority voting rule is particularly important for the protection of minorities in countries like Ecuador where the democratic process is not circumscribed by a firm rule of law.

Fiscal decisions are important. The arithmetic of the budget shows us that two new fiscal rules would be sufficient to control the scope and scale of the government and protect minority interests. Total outlays minus total receipts equals the deficit, which in turn equals the increase in the total outstanding debt. Supermajority rules that limit any two of these variables would limit all the other variables. Which two variables should be limited? The easiest way to answer the question is to sketch, following Niskanen (1992), an amendment to the Ecuadorian constitution:

> Section 1. The total Ecuadorian debt may increase only by the approval of two-thirds of the members of the Congress.
> Section 2. Any bill to levy a new tax or increase the rate or base of an existing tax shall become law only by approval of two-thirds of the members of the Congress.
> Section 3. The above two sections of this amendment shall be suspended in any fiscal year during which a declaration of war is in effect.

Deregulation. Ecuador's economy is wrapped up in red tape and regulations. A big part of the burden for a new business is what might be called the entry tax. How much, in the way of government-mandated costs, does it take to start a new limited-liability company? This is an important question because new enterprises foster competition.

In addition to onerous entry costs, the Ecuadorian economy is plagued by regulations that impose undue inflexibility on its labor market, resulting in government-imposed unemployment. The procedural complexity associated with the enforcement of contracts is relatively high, too. This long duration increases the uncertainty associated with the outcome and contracting costs. If this is not bad enough, creditors' rights and bankruptcy laws are relatively weak (The World Bank 2003). Accordingly, risk premiums and interest rates are higher than if contracts were easier to enforce and creditors' rights and bankruptcy laws met higher standards.

Ecuador should mount a major deregulation campaign along the lines of that which was implemented in New Zealand (Brash 1996). Such a campaign would cut red tape, clarify and improve the rules of the game (for example, in the electric power generating sector) and give the economy a competitiveness boost (Alesina, et al. 2003).

Privatization. The public cost incurred in providing a given quantity and quality of output is about twice as great as private provision. This result occurs with such frequency that it has given rise to a rule-of-thumb: "the bureaucratic rule of two" (Hanke 1987). To sharply reduce the costs of goods and services and enhance Ecuador's competitiveness, government-owned enterprises should be privatized.

The energy sector should be at the top of the government's privatization list. At present, the energy sector (including Petroecuador) suffers from massive waste, fraud and abuse (Eifert, Gelb and Tallroth 2002). This represents nothing more than the "curse of oil" (Economist 2003).

And Ecuador is not the only country to suffer the ills from the curse, particularly corruption. A sampling of the recent press tells the tale.

Privatization of the oil sector should be comprehensive, including the current producing oil fields, potential fields and all transportation, storage and refining operations (for sound ideas on how to privatize, see Adelman 2003, Lee 2003, and Jenkins 2003).

What should be done with the privatization revenues? First, they should be used to liquidate Ecuador's debt. And second, the remaining revenues should themselves be privatized equitably and distributed to the Ecuadorian people. After all, doesn't Ecuador's oil belong to the Ecuadorian people?

Public Opinion on Dollarization

The Ecuadorian people have long yearned for more economic freedom and stability. The public's approval of dollarization is a testament to the people's recognition of its sustained success. In December 2014, approximately 15 years since the measure was implemented, a public opinion survey in Ecuador showed that 85% of people approved of dollarization (El Comercio 2015). Indeed, the financial stability and convenience rooted in the dollar are often cited as the main reasons for its continued widespread public support.

Despite the unequivocal economic success and public approval of dollarization, in 2014, politicians --such as Ecuadorian President Rafael Correa-- still try to win publicity points by deflecting blame onto dollarization whenever economic policies go awry (Gill 2014). However, President Correa, like other dollarization detractors, cannot refute the stability dollarization has brought to the country. His criticisms and stated desire to replace the dollar with a local currency are simply empty political rhetoric, which falls on deaf ears. For any elected official, going against public opinion, not to mention the plethora of economic data, would be political suicide.

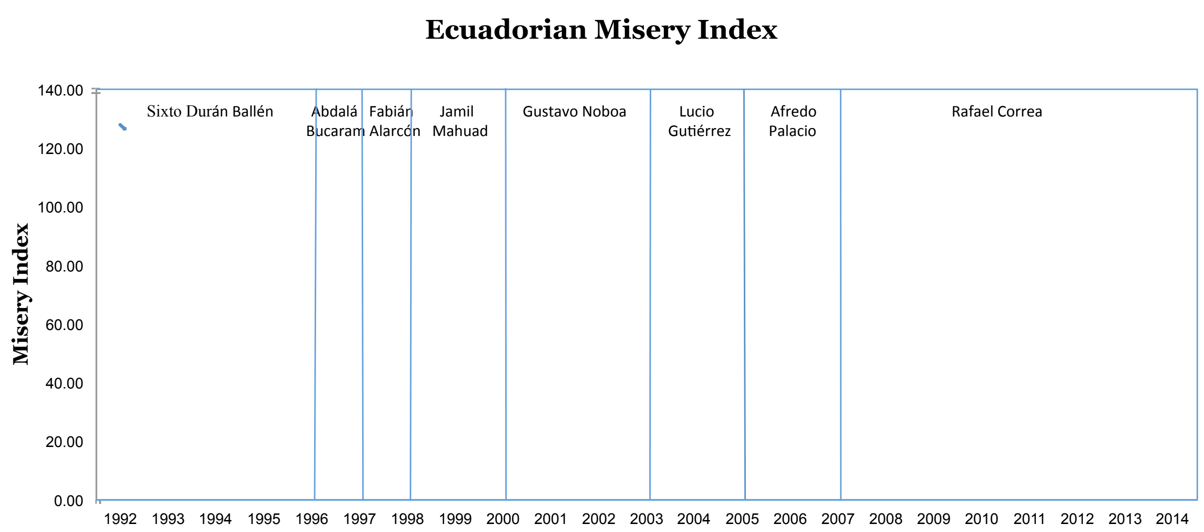
The Misery Index

The misery index is an even more rigorous and objective method to measure the state of the economy than public opinion polls. First devised by the late Arthur Okun, a distinguished economist who served as chairman of the President's Council of Economic Advisers during President Johnson's administration, and later revised by Harvard Professor Robert Barro, the misery index measures, in economic terms, how "miserable" citizens are within a given country (Hanke 2014). The index is equal to the sum of the inflation rate (end of year), bank's lending interest rates, and unemployment rate minus the actual percentage change in GDP per capita. Simply put, a high index means high misery.

In Ecuador, prior to the implementation of dollarization in 2000, the country sustained a misery index of over 120. The public suffered greatly from inflation, but after dollarization was implemented, high inflation was immediately stifled and misery drastically fell. Figure 1 shows the direct correlation between dollarization and the immediate and sustained decrease in misery. From 2003 through 2014, the misery index in Ecuador has been remarkably consistent at around 20.

Given that dollarization was responsible for the significant reduction in misery, it is, therefore, no surprise that the Ecuadorian people continue to support the measure. Unlike some politicians and political activists who demonize dollarization in their populist rhetoric, the public sees the objective benefit of dollarization (read: the misery index) as a major source of stability.

Figure 1.



Sources: World Bank, International Monetary Fund, and calculations by Prof. Steve H. Hanke, The Johns Hopkins University.

Methodology: Misery Index = Inflation Rate (End of Year) + Bank's Lending Interest Rates + Unemployment Rate - Actual % Change in GDP per capita

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