

ADMINISTRATIVE ARRANGEMENT

December ~~27~~, 2006

With reference to the Cooperation Framework Arrangement (the "Framework Arrangement") dated as of October 3, 2004 between the Government of the United Kingdom of Great Britain and Northern Ireland (the "U.K.") represented by the Department for International Development ("DFID"), and the Inter-American Development Bank (the "IDB"), I am pleased to inform you of the intention of DFID to make available a contribution (the "Contribution") of fifty thousand Pounds Sterling (£50,000.00), to be administered by the IDB for the project: "Second Stage of Building Social Capital through Fiscal Reform", IDB project RS-X1071 (the "Project").

The provisions of the Framework Agreement will apply to this Administrative Arrangement. The IDB will administer the Contribution in accordance with the provisions of the Framework Agreement, except as otherwise provided herein. The financial reporting will be expressed in U.S. dollars.

The Contribution is for a COFAB and will be used exclusively for the purposes and objectives set out in the attached Project document.

Special reporting requirements: pursuant to the Framework Arrangement (provisions 5.1.2 (a) and (b)), the IDB will not provide audited financial statements for the Project. Nevertheless, DFID may request that the IDB have its external auditors issue a special report related to this Administrative Arrangement, based on agreed-upon procedures and paid according to the second paragraph of provision 4.2.6 of the Framework Arrangement.

DFID will deposit the Contribution, upon written request from the IDB, in one single installment, into the account indicated by the IDB promptly following the date hereof, in accordance with the following schedule:

£50,000 (fifty thousand Pounds Sterling)

Upon signature of this Administrative Arrangement.

The payment schedule may be amended with DFID's written approval dependent on actual expenditure and need.

The officers responsible for coordination of all matters related to this Administrative Arrangement are:

For DFID:

Martin Johnston
Head, DFID Central America
and First Secretary of Development
Department for International Development

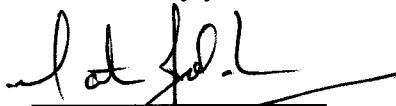
For the IDB:

Bertus J. Meins
Chief, Cofinancing Division
Financial Support Services Subdepartment
Regional Operations Department 2
(RE2/FSS/CEP)

The IDB's commitment to use the Contribution as contemplated herein remains subject to the IDB's formalization of all internal approvals necessary for the Project.

I would like to propose that this letter, upon your confirmation where indicated below, constitutes an arrangement under the Framework Agreement between DFID and the IDB.

Sincerely yours,



Martin Johnston
Head, DFID Central America and
First Secretary of Development

Confirmed and agreed:

Inter-American Development Bank



Bertus J. Meins
Chief, Cofinancing Division
Financial Support Services Subdepartment
Regional Operations Department 2

COFAB
Non Reimbursable Contribution administered by the Bank
Cooperation Framework Arrangement between the UK and IDB

NICARAGUA AND HONDURAS
Plan of Operations

RS-X1071

I. GENERAL INFORMATION:

- | | |
|---|---|
| 1. Name of the Project | Second Stage of Building Social Capital through Fiscal Reform |
| 2. Name of the Donor: | UK-DFID |
| 3. Beneficiary country: | Nicaragua and Honduras |
| 4. Beneficiary agency: | Ministry of Finance in each country |
| 5. Estimated Total Amount to be financed: | DFID (COFAB) £50.000
US\$95.455 |
| 6. Execution and Disbursement Deadlines: | 12 and 15 months respectively |

II. OBJECTIVES:

- 2.1 This COFAB operation will promote modernization of the fiscal systems in Nicaragua and Honduras through a set of reforms that have the potential of increasing tax revenue by 3-4 percent and significantly increase efficiency in public expenditure management and the delivery of services. The project will contribute to the continued building of knowledge on fiscal issues and promote recommendations for fiscal reform. Through a series of seminars and meetings with the respective governments and stakeholders, this project seeks to promote dialogue and to build awareness and consensus on core issues of fiscal policy.
- 2.2 With the aim of providing consistent and updated knowledge that approach fiscal issues from a number of complementary angles to decision makers, pressure groups, and stakeholders, the project will focus its activities around i) contracting international experts to update existing studies and conducting complementary studies on tax and expenditure issues; and ii) conduct a series of seminars, meetings, and trainings in order to spur debate and build consensus, in order to set the agenda for the further reform agenda.

III. DESCRIPTION:

- 3.1 Modernization of the fiscal management system is the outcome of a large set of incremental reform efforts pulling in the direction of international best practices. However, extensive dissemination of the recommendations and efforts to frame the message according to the socio-political context are required in order to build consensus on the path to reform. This project seeks to spur such consensus by conducting a whole range of activities among

selected stakeholders.

3.2 Output required in Nicaragua:

- a. Update spending and tax analyses
- b. Present studies to incoming government and legislature
- c. Discuss studies with civil society organizations and media

3.3 Output requires in Honduras:

- a. Launch tax book late
- b. Fiscal guidelines for sustainable macroeconomic policy within the Honduran social and economic context. Study and dissemination.
- c. Prepare a comprehensive tax reform proposal that includes viable policies, guidelines for administration and legal documents for reform.
- d. Launch expenditure book mid-2007
- e. Various dissemination activities
 - i. Activities for civil society organizations, business, unions, public sector, government, legislature, international donors
 - ii. Bring international experts to hold seminars on fiscal issues

3.4 **Duration:** The estimated duration of this COFAB operation is 15 months. During this period international consultants will conduct the above-mentioned studies according to specific contracts and the project team will carry out the activities in close cooperation with the governments and identified stakeholders.

IV. JUSTIFICATION:

- 4.1 The role of a potent and capacitated state in building human capital has become a priority focus in the Central American countries. Low revenue levels and inefficient finance management and service delivery are causing weak state capacity and subsequent deficiencies in basic service provision. These are weaknesses that affect almost every aspect of daily life, and both in terms of quantity and quality severely limit each individual's possibility to improve life quality. The detriment effects on the overall human capital levels are equally brutal and produce binding constraints to sustainable and broad-based growth. Consequently, modernization of tax policies and expenditure practices have become recognized as key elements in building growth-conducive state capacity.
- 4.2 The Bank, with financing from SIDA, DFID, and NORAD, has since 2001 been in the forefront of promoting fiscal reform in the Central American region. Extensive initiatives have been conducted in order to disseminate and build consensus on recommendations put forward in a series of thematic studies on tax policy and expenditure management.
- 4.3 At the heart of the recommendations is the need to raise tax revenue in order to reinforce macroeconomic stability and increase social spending. Primarily, the increase in revenue is to be achieved by implementing reforms that will broaden the tax base while keeping rates constant. In particular, closing loopholes, doing away with arrangements that benefit special interest groups, and in other ways ensure a more just system, are among the recommended

actions. However, the state is often perceived as being incapable of catering to basic needs due to intrinsic efficiency shortfalls and claims about corruptive practices. Therefore, the bank efforts have been based on the recognition that reform of tax policies have to be accompanied by reforms that increase efficiency and effectiveness and improve transparency in public spending as well.

- 4.4 The incremental characteristic of fiscal reform requires that IDB recommendations are up to date and take the latest advances in each country into account. Also, given the variety of stakeholders, among which consensus will be sought, it is necessary to approach the topic from a number of angles. One particular case in point is the approach of analyzing fiscal incidence; i.e. which are the groups actually paying taxes and which are the groups receiving the benefits. This approach has proven to be a way to build bridges between the areas of tax policy and expenditure management and is a powerful instrument in building awareness about the purpose and actual functioning of the fiscal system.
- 4.5 Indeed, technically sound recommendations are only one of the necessary requirements needed to be met in order to move forward. Promoting dialogue and building consensus on the direction for fiscal reform have proven to be of equal importance. However, this requires that the message be framed according to the socio-economic context in which it is presented. This technical cooperation will provide the means to continue the extensive dissemination efforts outlined in the strategies for Nicaragua and Honduras and to provide specific reform platforms, including the legal and institutional frameworks for needed tax policy changes.

V. SOCIAL AND ENVIRONMENTAL IMPACT

The Committee on Environmental and Social Impact (CESI) reviewed the profile for this operation on its meeting of September 26, 2003. The CESI concluded that due to the nature of this program, no environmental or social impacts are expected.

VI. BUDGET:

- 6.1 The estimated budget is US\$95.455.

Nicaragua		
Study updates	US\$ 10.000	£ 5.238
Dissemination seminars	US\$ 17.300	£ 9.062
Honduras		
Fiscal-Macro study and presentation	US\$ 25.000	£13.095
Tax reform guidelines updated studies	US\$ 20.000	£10.476
Dissemination seminars	US\$ 17.428	£ 9.129
Fee 5%	US\$ 4.773	£ 2.500
Contingency 1%	US\$ 954	£ 500
Total Donor Contribution	US\$ 95.455	£50.000

*Exchange rate according to the US Federal Reserve, as of November 1, 2006. US\$1=£1.9091.

VII. RESPONSIBILITY IN THE BANK:

- 6.1 The project will be carried out at the field level and at Headquarters. The technical responsibility and the responsibility for approving disbursements will rest with the Project Team and its Leader Susana Sitja-Rubio, Modernization of State Specialist for SC2, Tel. (202) 623-3805, e-mail: susanasi@iadb.org. Team members will include Vibeke Oi (RE2/RE2), Miguel Manzi (RE2/OD3) and Pablo García (RE2/OD3).
- 6.2 **Responsibility for Disbursement:** The Cofinancing Division (RE2/FSS/CEP) will have the responsibility of the disbursements of the donor to the Bank. The Country Division of Regional Operations Department II (RE2/OD3) will have the basic responsibility of this operation and its disbursements.

VIII. RECOMMENDATION:

- 8.1 Susana Sitja Rubio, designated team leader for the project of the reference, recommends the approval of this operation and the use of resources from the UKF United Kingdom Fund totaling up to £50.000 in order to finance the corresponding project.