

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

PUBLIC MANAGEMENT REFORM PROGRAM

(HO-0223)

LOAN PROPOSAL

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Annex II	Results Matrix (see electronic links and references)
Annex III	Macroeconomic Assessment (see electronic links and references)

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Proposed resolution

Electronic Links and References	
Basic Socioeconomic Data	http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata
Status of loans in execution and loans approved	http://ops/approvals/pdfs/HOen.pdf
Tentative lending program	http://opsgs1/ABSPRJ/tentativelending.ASP?S=HO&L=EN
Information available in the RE2/SC2 technical files	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=583122
Policy Letter	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=749713
IMF Evaluation Report (confidential)	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=750358
Annex II – Results Matrix	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=750363
Annex III – Macroeconomic Assessment (confidential)	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=750378

ABBREVIATIONS

AWP	Annual Work Plan
BCH	Central Bank of Honduras
CAFTA-DR	Free Trade Agreement between the United States, the Central American countries, and the Dominican Republic
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Review
DEI	Dirección Ejecutiva de Ingresos [Revenue Office]
FTA	Free trade agreement
GFs	Gerencias Financieras [financial management offices]
HIPC	Heavily Indebted Poor Countries Initiative
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
NIR	Net international reserves
ONCAE	Oficina Nacional de Compras y Contrataciones del Estado [National Office of State Purchases and Contracting]
PDL	Performance-driven loan
PEFA	Programa de Gasto Público y Rendición de Cuentas [Public Expenditure and Accountability Program]
PET	Program for Efficiency and Transparency in Government Procurement
PRGF	Poverty Reduction and Growth Facility
PRODEV	Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Credit
RTN	Registro Tributario Nacional [National Tax Register]
SEFIN	Ministry of Finance
SIAFI	Sistema Integrado de Administración Financiera [Integrated Financial Administration System]
SIDA	Swedish International Development Agency
SIGADE	Sistema de Gestión de Deuda Pública [Public Debt Management System]
TGR	Tesorería General de la República [General Treasury of the Republic]
TSC	Tribunal Superior de Cuentas [Court of Accounts]
UAIs	Unidades de Auditoría Interna [Internal Audit Units]
UAP	Unidad Administradora de Proyectos [Project Administration Unit]
UNAT	Technical Support Unit
UPEGs	Unidades de Planeamiento y Evaluación de la Gestión [Management Planning and Evaluation Units]
WTO	World Trade Organization

PROJECT SUMMARY

HONDURAS PUBLIC MANAGEMENT REFORM PROGRAM (HO-0223)

Financial Terms and Conditions				
Borrower: Republic of Honduras			Amortization period:	40 years
Executing agency: Ministry of Finance			Grace period:	10 years
Source	Amount	%	Disbursement period:	24 months
IDB (FSO)	US\$30,000,000	100	Interest rate:	1% for the first 10 years, 2% thereafter
Local	-	-	Inspection and supervision fee:	1% of the loan amount
Other/Cofinancing	-	-	Credit fee:	0.5% on undisbursed balances
Total	US\$30,000,000	100	Currency:	U.S. dollars or equivalent in convertible currency
Project at a glance				
Project objective: The objective of this program is to support the Government of Honduras in improving economic governance through a gradual reform of public management that will promote greater effectiveness and efficiency in the use of resources. The policy reform matrix is divided into six action areas: (i) Macroeconomic Stability; (ii) Institutional Framework for Results-based Management; (iii) Revenues: Tax and Customs Administration; (iv) Public Financial Management; (v) Procurement Management; and (vi) the Control Environment				
Special contractual conditions: Disbursements under this loan will be subject to compliance with the policy conditions set forth in the Matrix of Policy Conditions (Annex I)				
Exceptions to Bank policies: None.				
Project consistent with country strategy: Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Project qualifies as: SEQ <input type="checkbox"/> PTI <input type="checkbox"/> Sector <input type="checkbox"/> Geographic <input type="checkbox"/> Headcount <input type="checkbox"/>				
Verified by CESI on: 25 February 2005 Procurement: See paragraph 3.7				

I. FRAME OF REFERENCE

A. Socioeconomic framework

- 1.1 Despite the progress, as reflected in the social indicators for the decade of the 1990s,¹ Honduras remains the third poorest country in Latin America and the Caribbean in terms of per capita income. Two out of every three people are poor, and nearly half the population is living in conditions of extreme poverty. The situation is worse in rural areas, where 64.2% of the population lives in poverty, compared with 58.7% in urban areas.²
- 1.2 The challenges posed by poverty reduction have led Honduras to revise its development agenda, based on the Poverty Reduction Strategy (PRS), as the cornerstone of the country's development. The PRS, prepared as part of the Heavily Indebted Poor Countries (HIPC) Initiative, seeks to combine a solid macroeconomic framework with accelerated growth, driven by increased competitiveness and actions in various sectors and geographic areas to bring the benefits of development to all Hondurans. In this context, the key challenges facing Honduras are: (i) to enhance economic stability; (ii) to boost growth by improving competitiveness; (iii) to advance the development of human capital; (iv) to improve the environmental sustainability of growth and reduce vulnerability to natural disasters; and (v) to improve governance and strengthen the country's institutions.
- 1.3 To increase economic stability and support the PRS, the country signed a Poverty Reduction and Growth Facility (PRGF) arrangement with the International Monetary Fund (IMF) in 2004. The PRGF is a concessional facility that the IMF maintains for low-income countries. It is supporting the implementation of structural investment, and trade liberalization reforms as ways of strengthening economic growth and reversing the country's financial deterioration. The program seeks to support measures that will generate annual GDP growth of 4.5% between 2006 and 2008. It also seeks to reduce the deficit to levels that can be financed with external concessional support, from 4.5% of GDP in 2003 to 1.75% of GDP in 2006. This deficit reduction, together with debt relief through the HIPC Initiative, will make the fiscal situation sustainable over the medium term.
- 1.4 The principal challenge of the government's fiscal program for 2005 was maintaining fiscal discipline in a context of political transition and oil price increases. The objective was to cut the central government deficit to 3.2% of GDP, a target that was exceeded inasmuch as, according to preliminary figures, the deficit

¹ During the 1990s the incidence of poverty declined by nine percentage points. During that same period, Honduras achieved a significant reduction in the proportion of households with Unmet Basic Needs (UBN), from 67% in 1990 to 48% in 1999, and the Human Development Index (HDI) also improved under the impact of various social programs.

² "Honduras: Enhanced Initiative for Heavily Indebted Poor Countries. Completion Point Document." World Bank, March 2005.

stood at 3.1%. Program targets for 2005 as well as 2004 called for generating current government savings at levels close to those of the late 1990s, so as gradually to improve the capacity to increase spending on poverty reduction, which is the ultimate objective of international assistance. According to official figures from the Central Bank of Honduras and the Finance Ministry (SEFIN), shown in the following table, the targets for the 2005 fiscal program were fully achieved.

Table 1: Central Government Fiscal Indicators

Year	Real GDP growth rate	Central government deficit (% of GDP)	Tax revenues (% of GDP)
2001	2.6%	-5.3	16.2
2002	2.7%	-4.8	15.9
2003 ³	3.5%	-5.5	16.6
2004	5.0%	-3.5	17.4
2004 (Program)	3.5%	-3.5	17.5
2005	4.2%	-3.1	17.3
2005 (Program)	4.0%	-3.2	n/a
2006 (Program)	5.1%	-2.5	n/a

Sources: BCH, SEFIN-Accounting and SEFIN-UPEG

- 1.5 In May 2006, the fourth program with the IMF (PRGF) concluded favorably. This consultation confirmed that macroeconomic indicators have improved recently and growth rates were revised upward, driven by momentum in certain sectors. The external sector remains strong, due to export growth and higher remittances. While the report for this last review has not been completed, the report for the third PRGF report (at 31 December 2005) confirmed that the country's success on the macroeconomic front reflected sound fiscal policies and substantial progress with structural reforms, supported by remittances and foreign capital inflows. For 2006, GDP is expected to grow by 5.1% and the public sector deficit should fall to 2.5% of GDP. The macroeconomic situation is expected to remain stable.
- 1.6 This program, a two-tranche policy-based loan, helps to improve the capacity of the Government of Honduras to face the challenges and social, political, and economic costs inherent in the implementation of the PRS, which requires improving spending effectiveness, given the fiscal constraints that the country is facing in order to maintain macroeconomic stability. This implies the need to establish an institutional framework for planning; strengthen collection capacity; improve the functionality and effectiveness of financial management; strengthen the reliability of financial information and impact monitoring; and ensure the effectiveness and transparency of management processes (control).

³ As noted in the SEFIN annual report for 2003, the annual deficit of 5.5% included a transfer of L.1,250 million to FONAPROVI, which involved a debt increase rather than a movement of funds.

B. Governance and public institutions

- 1.7 In the context of strengthening governance and institutions, the Government of Honduras has been faced with a complicated fiscal situation that has required taking steps on both the expenditure and the revenue fronts to correct that situation.
- 1.8 In January 2004 the government, the IDB and the World Bank reached agreement on two analytical documents: the Country Financial Accountability Assessment (CFAA) and the Country Procurement Assessment Review (CPAR). Based on the recommendations contained therein, a sweeping reform of public financial management was undertaken. On this basis, and through additional measures, the government reached an agreement with the IMF under the Poverty Reduction and Growth Facility (PRGF), which was signed on 2 February 2004.
- 1.9 The analyses contained in the CFAA and the CPAR, and those conducted during preparation of the other operations relating to this program, have revealed some major weaknesses with respect to public-sector governance and the fiduciary responsibility of civil servants. Addressing those weaknesses will entail improvements in planning, budgeting, financial information, government procurement management, revenues and management control, areas that have a direct bearing on the country's capacity to achieve the targets set in the PRS. The key aspects of the analyses conducted are discussed below.

1. Institutional framework for results-based management

- 1.10 *Planning.* In follow-up to the progress made to date under the PRS, a planning structure is needed that will clearly delimit the budget planning functions at the macro and sectoral levels and allow the definition of indicators and expected outcomes from this activity.
- 1.11 The Budget Act, which has been in effect since January 2005, provides that the national budget must be prepared on the basis of medium-term targets. This means that a Multiyear Medium-term Framework will have to be designed, based on sectoral plans, in order to relate the PRS targets to their costs and to present them appropriately in the budget programming documents.
- 1.12 The Technical Support Unit (UNAT), which is part of the President's Office [*Secretaría de la Presidencia*], is the body responsible for macro-level planning and for developing methodologies to select impact and output indicators consistent with the PRS. That unit's institutional weaknesses have prevented it from fulfilling these tasks. Moreover, as noted in the CFAA, the budget was presented in terms of expenditure categories rather than program classifications, which made it impossible to supervise and evaluate public spending against agreed priorities for economic growth and poverty reduction.

- 1.13 The Public Administration Act and its regulations do not clearly delimit the planning functions of the various component institutions. Thus, the Management Planning and Evaluation Units (UPEGs) for each institution are geared to preparing Annual Work Plans (AWPs) instead of sectoral strategies and conducting performance evaluations. On the other hand, the Financial Management Offices [*Gerencias Financieras*] prepare the draft budget, which does not match the AWP, causing a shortage of information for monitoring budget execution. Effective budget management requires that the AWP be consistent with budget formulation, an aspect that will be facilitated if there is an explicit process of coordination between the responsible entities. The lack of planning at the sector level also means that sectoral expenditure policies do not reflect PRS targets as effectively as they should. The budget should be based on the government's expenditure priorities, which should be set forth in the poverty reduction strategy paper. The guidelines established in the strategy should be reflected in the AWP and other planning documents so that they can be accurately reflected in the budget. This means that there is an inescapable link between budgeting and planning.
- 1.14 *Results-based public management.* The legislative framework for government management, represented in particular by the Public Administration Act, is focused mainly on the control and use of public funds, without placing importance on fulfilling objectives, policies and targets. The above-mentioned weaknesses of the planning system, the lack of clear output and impact indicators in the public budget, and the absence of standards to guide programming and results-based management, are the basic factors explaining why the country does not have an administration that places priority on achieving ends rather than controlling means.
- 1.15 Honduras has made it a development goal to fulfill the targets in the PRS. The country is also in the process of developing programs for financing through SWAPs (sector-wide approach), and was one of the first Bank customers to approve a PDL (performance-driven loan) operation. Both instruments demand management methodologies that focus on goals and not exclusively on resources, and they also require reliable and verifiable information and, in particular, output and outcome indicators. The goals-oriented management methodology requires a series of policy and administrative reforms in order to support its implementation, which should be done gradually, seeking to develop good practices in key institutions prior to expanding it to the entire public sector.
- 1.16 *Administrative organization of SEFIN.* The Finance Ministry (SEFIN) fulfills several roles: (i) it is responsible for the financial administration and investment systems; (ii) it is responsible for providing service to the public for transactions such as those related to the granting of franchises; and (iii) like any ministry it conducts a number of internal procedural activities involving the contracting of goods and services and it exercises the responsibilities assigned to executive branch ministries by current legislation, such as preparing draft laws and decrees and issuing resolutions.

- 1.17 The slowness and delays in the way that the Ministry conducts its procedures not only detracts from the efficiency of its own performance but also affects the other government agencies, given its policy-making role, as well as the general public. Efficient management of the public sector requires an effective and efficient Finance Ministry. As the agency in charge of financial administration and investment systems, its implementation of the new Integrated Financial Administration System (SIAFI) (see country strategy section) calls for a considerable reduction in the number of procedures and a reduction in time periods and the steps for implementing those that will remain in force. At the same time, approval of the new Budget Act⁴ and its regulations will entail a structural redefinition of SEFIN, at least in those administrative areas related directly to the financial administration and investment systems.

2. Revenues: Tax and Customs Administration

- 1.18 While planning is a priority concern for effective public management, the State must have the capacity to collect taxes if it is to have the economic means needed to carry out actions that support poverty-reduction goals. Beginning in 1994 Honduras set out to strengthen and modernize the revenue system, and it has merged internal customs and revenue management into a single institution, the Dirección Ejecutiva de Ingresos [Revenue Office] (DEI), an entity that enjoys budgetary and operational autonomy.
- 1.19 That merger, which the Bank supported, produced improvements and economies of scale in the use of common services, but it failed to take advantage of the potential synergies for improving revenue performance in both areas, because a strategy and a coordinated action plan were lacking. While information systems were certainly improved, the lack of follow-up investment in them has rendered them obsolete. Thus, the information available is not reliable for addressing the challenges and commitments of rationalizing management processes, audits, and taxpayer services, in the complex and demanding environment posed by the regional integration process and trade agreements.
- 1.20 The CFAA identified the following weaknesses in the DEI: (i) it has limited operational capacity to carry out its responsibilities properly, reflected primarily in the inefficient use of its resources and the relative obsolescence of its technologies and working methods; (ii) it lacks suitable technological tools for tax and customs administration; and (iii) there are major weaknesses in the tools required for tax administration, primarily in terms of the lack of timeliness and reliability of the data in the Taxpayer Registry, the taxpayer accounts for controlling compliance, and revenue collection and analysis against initial estimates. One example of the foregoing is the fact that the internal revenue administration does not know what it is supposed to collect, and therefore there is no analysis of the degree of evasion.

⁴ Approved on 28 May 2004.

This is because of the lack of reliable information, since much of the data supplied to the DEI is not in electronic format and cannot be incorporated into its database, which means that the total tax debt on a taxpayer's current account is not known.

- 1.21 Since the end of 2004 the DEI underwent a thorough structural and institutional overhaul. The institution lost the managerial, budgetary and staffing autonomy that it previously enjoyed under the deconcentration regime, and it has been integrated into the SEFIN structure and now falls under the Civil Service Act. This new situation has exacerbated the lack of operational coordination in the control of customs and tax revenues, by adding two new elements of instability: one stems from the lack of clarity in the new organizational structure and common services, while the other relates to the personnel system. The situation poses a significant risk to what is a key institution for the country's governance.
- 1.22 The Tax Code reform, introduced in December 2004 by Legislative Decree 210-2004, makes changes to meet the recommendations and conditions in the PRGF arrangement with the IMF in terms of strengthening the DEI's jurisdiction and legal authority to collect taxes and make taxpayers pay their debts, by introducing payment facilities and more realistic penalties against tax fraud and evasion. These new legal powers will require a DEI with a clear organizational structure and the capacity to carry out the functions assigned to it.
- 1.23 A milestone on the customs administration front was the approval in May 2004 of Executive Decree 004-2004 creating the Special Interagency Commission for Modernization of the Customs Service, with representatives of the public and private sectors, as an advisory body to the President and a permanent consultative institution for monitoring, analysis, evaluation, and formulation of recommendations on customs matters that will promote transparency and simplification in this administrative sector. Its most recent task was to select new customs administrators through open and transparent competition.
- 1.24 Despite the steps taken to modernize customs administration, the recent "triangulation" operation—where third country imports are fraudulently reexported as domestic products—involving fuel smuggling, which affected several member countries of the Central American Customs Community, highlighted the current shortcomings of Honduran Customs Office's information, operational control, and supervision system. Without attempting to justify the situation, it must be recognized that most of the investment in modernizing the customs service over the last five years has gone into implementing an information management system of very limited scope. This means that if the DEI is to improve its management of revenue collection and control of trade, it must change its procedures and systems for capturing and processing information in order to make them more secure and reliable.

- 1.25 Still on the customs front, attention must be drawn to the mismatch between current legislation and the reality of trade and integration. Customs uses a regional standard, the Uniform Central American Customs Code (CAUCA) and the regulations thereto (RECAUCA), which provide general rules governing operational aspects and leave it to domestic legislation to fill in the details and to specify supervisory and enforcement procedures. Thus Honduras has as its basic legislation a Customs Act dating from 1987, in addition to specific regulations relating to this area in the tax code. The trade streamlining objective, introduced by the WTO agreements, and the current drive towards Central American integration have changed the way the customs administration works, shifting the audit burden to a stage subsequent to customs clearance, which was not the case in 1987. This new audit strategy is not fully covered by the current law or current regulations, a situation that poses a significant impediment that could affect the collection of customs duties or else hold up the clearance of merchandise. A new CAUCA, agreed upon in the context of the Central American Economic Integration system (SIECA), will address the shortcomings of the Honduran legal system and its entry into force is a key aspect of improving customs administration.

3. Public financial management

- 1.26 The government instituted the Integrated Financial Administration System (SIAFI) in the second half of the 1990s. That system for recording financial transactions (expenditures and resources) was not accompanied by the administrative reengineering needed to link resource management with the respective book entries. This gave rise to a mismatch between expenditures and budgetary forecasts, which are "regularized" in the accounts only after they occur, a situation that makes it difficult to obtain a reliable estimate of the floating debt.
- 1.27 *Budget.* On the budget front, while there is an adequate conceptual framework for reviving the technique of program budgeting, the aforementioned weakness of the planning system render that technique formalistic, and it has not had the expected impact on management. Since external cooperation is considering granting program loans, it is essential to have an effective program budget classification in order to maintain consistency and to manage funds in sector-focused programs.
- 1.28 In addition, successful resource management with a sectoral focus will require observance of the principle of budget universality. For example, the total amount contracted for projects in execution with nonreimbursable financing in 2004 and 2005 was US\$730.8 million, of which US\$549.6 million (75.2%) was included in the annual budgets, while the remaining US\$181.2 million (24.8%) was not to be found in the budgets for those years.
- 1.29 *Treasury.* During preparation of the CFAA in 2003 it was found that there was no legal framework defining the functions of the General Treasury of the Republic (TGR) and that it was limited to acting as the government's cashier, without any

programming tool or any means to control financial instruments and payments. At the same time, the functions of public fund management were found to be shared by the Budget and Public Borrowing Directorates and the Central Bank of Honduras (BCH). The CFAA proposed that, once the new Budget Act was approved, the government should move forward with a specific program to transform the TGR into a modern government agency capable of exercising its lead role in the management of public funds. The Budget Act was approved in May 2004, by Legislative Decree 83-2004: Title V establishes the Treasury Subsystem in the form of a Master Account System, and gives the TGR new powers as the technical coordination body for that system.

- 1.30 The government's lack of a financial management office with sufficient legal powers and management tools made it impossible to reconcile budget execution with fiscal policy objectives and with the country's poverty reduction strategy. In this respect, now that the Budget Act has removed the legal obstacles to transforming the TGR from a cashier into a true financial management office for the government, the main problem remaining is the lack of rules, management tools, and institutional resources that would allow SEFIN and the TGR to give effect to the legal framework already approved.
- 1.31 *Public borrowing.* The CFAA identified functions performed in the Directorate of Public Borrowing (DGCP) that should belong to other government entities. For example, the DGCP acted like a treasury, issuing debt-servicing instructions directly to the BCH. It also managed the availability of funds from multilateral organizations in special project accounts in the BCH. In both cases, these functions should be performed by the TGR. The problem reflects in part a lack of clarity as to the responsibilities of the various divisions and units within SEFIN, and the absence of a management system that would clearly determine the jurisdiction of its component units.
- 1.32 It is also essential that the information recorded in the Public Debt Management System (SIGADE) should be entered in the SIAFI in real time. This would allow debt transactions to be taken into account in establishing and executing the budget. All anticipated debt service payments should be included in preparation of the budget, so that the budget can become the prime tool for public sector financial management and planning.
- 1.33 *Accounting and administration of assets.* The General Accounting Office is the central regulatory and administrative unit responsible for the system of public accounts. It is in charge of approving accounting procedures and systems, recording public sector transactions, presenting monthly and annual financial statements of the public accounts, and recording and administering public assets.
- 1.34 The CFAA identified the need for a review of the government accounting function, in order to prepare a manual on public accounting and a chart of accounts to

facilitate the move from a transactional approach to a broader analytical function focused on the principle of preparing information for safeguarding public assets and the treasury, and for accurately measuring the government's financial situation. Part of the problem in incorporating this new function was that there were no accounting procedures or chart of accounts applicable to all central government institutions. Uniform accounting procedures would enable financial accountability to facilitate government decisions in managing national resources and assets.

4. Management of procurement

- 1.35 In 2003 and 2004 the average volume of public sector procurement in Honduras was US\$1 billion, including goods, services, and public works. This represented 39% of total budgeted expenditures, and an increase of 28% over the previous year. Honduras does not have a good public procurement system: the current one is fragmented, with many users and varying standards, as well as organizational and institutional inconsistencies. This situation leads to increased administrative costs as a result of numerous budgetary inefficiencies and the lack of transparency in reporting.
- 1.36 Although Honduras issued a modern public procurement law in 2001, it has been implemented only partially. Current rules and policies vary depending on the capacity of the entity doing the purchasing, the origin of the funding, and the type of goods and services acquired. In a country that is poor and highly indebted, efficient and transparent management of public resources is a key consideration for economic development and for reducing poverty. Moreover, the lack of uniformity in procurement procedures makes it impossible to ensure that the budgetary commitment, authorization, and payment are duly approved and recorded before the purchase is made.

5. The control environment

- 1.37 The new legal framework for controlling public funds, based on the constitutional reform of 2002, has two broad components: (i) external control (*a posteriori* audit) falls to the Court of Accounts (TSC), and is independent of public finance administration and budget execution; and (ii) internal control is the inherent responsibility of the Executive Branch. According to the Constitution, the TSC is the lead entity in the system for controlling public funds and is responsible for ex post audit of funds, assets, and resources administered by the State.
- 1.38 The Act Establishing the TSC provides for comprehensive, exclusive, and unitary external control based on the principles of legality, effectiveness, efficiency, economy, equity, and reliability. The Constitution also assigns the Executive Branch the obligation to conduct preventive audits on the performance of the Revenue and Expenditure Budget of the Republic, which means that it must establish and maintain internal controls over public financial administration

consistent with the general rules issued by the TSC and as stipulated in the Budget Act. Currently Honduras has no institutional structure for internal control consistent with the current legal framework, and this creates a vacuum in terms both of ex ante and ex post control within the public administration environment.

- 1.39 In the public sector as a whole, including its financial entities, there are about 75 internal audit units (UAIs), although the TSC estimates that there are as many as 90. Public sector UAIs issue an estimated 14 audit reports on average each year, while Price Waterhouse Coopers (PWC), in the context of the Bank's Program for Efficiency and Transparency (PET) (see paragraph 1.51), produces a monthly average of 50 inspection reports. Moreover, the TSC has an Internal Audit Department with formal responsibility for reviewing their reports, in order to verify compliance with the requirements and elements that should be included pursuant to the General Standards of Internal Audit. Nevertheless, the department has limited human resources, so there is no evidence that it fulfills this function completely.

C. Country strategy in the sector

- 1.40 Honduras has been engaged in reforms of its financial administration system. Those reforms reflect the importance attached to maintaining reliable and timely records on financial and physical execution of expenditure by government institutions. The government of President Manuel Zelaya, who took office on 27 January 2006, has reiterated the country's commitment to continuing with the transformation of public finances and implementing a management methodology in the public sector that has the goal of fulfilling the country's development results that are consistent with PRS goals.
- 1.41 Strengthening the legal framework for financial administration, with the approval on 28 May 2004 of the Budget Act, has been an integral part of the improvement process undertaken by the country. Recognizing the need to issue regulations and technical standards for implementing it, the Budget Act should be fully operational by fiscal year 2006, provided that work can be completed on all the outstanding items relating to regulations, procedures, and computerization. This is a key aspect for the country's ability to mount programs using the SWAs (Sector Wide Approaches) methodology, which requires the use of national management systems.
- 1.42 In this reform process, the government is being supported by a series of investment programs. Two projects (3414-HO and 3939-HO) sponsored by the World Bank and SIDA [Swedish International Development Agency] are designed to help improve PRS-related planning in the UNAT, to develop a computerized platform for the integrated financial management system, to provide reliable information on public funds, and to strengthen the TSC so as to improve its ex post control capacity. At the same time, IDB/SIDA loan 1546/SF-HO is intended to contribute to more effective revenue collection and more efficient and effective expenditure,

closer linkages between fiscal and monetary policy, and mechanisms to measure the impact of management on PRS indicators.

- 1.43 Those programs, taken together, are producing substantial improvements in public financial management. These include establishment of the new SIAFI which, when it becomes operational in fiscal year 2006, will mean that financial administration reform is based on a sound linkage of administrative management with record-keeping. Thereafter, no expenditure commitment can be contracted nor any payment made unless there is a corresponding budget allocation. Moreover, the procedures related to real and financial resource administration are being overhauled in the functional designs, for purposes of simplification.
- 1.44 *Public management.* President Zelaya's administration has a very clear perception of the problem inherent in a management structure focused solely on controlling means, and has recognized the need for gradual introduction of a new administrative methodology. To this end, the new SIAFI must address specific features in the general procedures for managing real and financial resources in order to make them more flexible, so that the organizations realign their management to fulfill the objectives and targets to which they commit in the process of expenditure planning and formulation.
- 1.45 *Revenue management.* With its absorption by SEFIN, the DEI's institutional structure will have to be improved, given the direct impact it has on revenue collection, expenditure, and competitiveness. Beyond the general and specific actions called for in the DEI component of 1546/SF-HO, there is an urgent need to strengthen the agency as an institution within SEFIN to improve its management and make it more transparent. This will require a DEI with an organizational structure that respects the following principles: (i) integration of common services, planning and risk management; (ii) differentiated management and oversight of customs and internal revenue; (iii) organizational simplification through centralization based on the use of information technologies; (iv) deconcentration of responsibilities and resource management; and (v) equalization of the units' powers, through the use of competing interests. Another key aspect of the DEI, following its absorption, is to address the new situation facing personnel management and staff members' careers in the civil service. The present project will provide support in this new area.
- 1.46 There has been some significant progress with respect to information on tax revenues. Tax collection data for 2004 show that the country's commitment under the multiyear PRGF signed with the IMF led to greater fiscal discipline and a consequent strengthening of the tools available to the SEFIN (which is responsible for execution of this program) for forecasting, budgeting, and monitoring tax revenues. Progress to date includes the following milestones: (i) tax revenues as forecast in the program were accurately reflected in the 2004 and 2005 budgets; (ii) tax revenue performance achieved the established targets, demonstrating that

- the forecasts were realistic; (iii) fiscal management now takes place within a medium-term (three-year) financial program, backed by the PRGF; and (iv) while the tax collection systems are not yet integrated and reconciled with SIAFI information, SEFIN's UPEG is using conventional data processing mechanisms to provide timely oversight and monitoring of compliance with the tax collection targets, as can be seen in the quarterly execution reports generated by SEFIN's UPEG.
- 1.47 Lastly, in addition to the reform of the tax code and other measures mentioned above, the DEI has been implementing measures to improve the revenue administration system, including: (i) complete overhaul of the National Tax Register (RTN), implementing the E-TAX system; and (ii) coverage of 100% of the large taxpayers through the electronic tax filing system, by incorporating all large taxpayers into the E-TAX system.
- 1.48 *Public financial management.* The Government of Honduras incorporated all external donations into the 2005 budget, through the issuance of the corresponding budgetary amendments. This required a commitment on the part of donor agencies so that all grants are reported to SEFIN and their administration recorded in the SIAFI. This is a key aspect for the success of SWAp programs, and will allow the authorities to administer external funds on the basis of achievement of objectives.
- 1.49 In the treasury and accounting area, swift progress has been verified in the following procedures: (i) the TGR's cash programming now takes account of monthly revenue and expenditure trends for the three previous fiscal years, adjusting them for inflation and known instances of deviation in order to establish the monthly quota; (ii) the newly introduced system for issuing payments takes account of the available balance, obtained from daily bank reconciliation, and the maturity dates of invoices substantiating the expenditure, thereby improving both control of the floating debt and the TGR's liquidity management; (iii) for purposes of establishing year-end accounts and producing financial management data, progress has been made in reconciling data between SEFIN (TGR and the General Accounting Office) and the Central Bank of Honduras, to the point where, at the close of 2004, bank account balances in the BCH were adjusted with the account balances produced by the General Accounting Office of SEFIN; (iv) a Chart of Accounts has been issued for the entire public sector; and (v) in 2005, the Treasury began analyzing the current accounts kept by institutions in authorized banks to determine, in light of existing rules, which ones should be closed and moved to the Master Treasury Account.
- 1.50 In the budget area, progress has been made under loan 1546/SF-HO: (i) the budget classifications have been adjusted in accordance with international standards for compiling and presenting fiscal statistics and they include a specific classification for monitoring fulfillment of the PRS; (ii) the chart of accounts of institutional classifications, of resources by heading and by expenditure object, has been

- adjusted in accordance with regulatory changes since 1988, the last year in which the chart of accounts had been adjusted; (iii) the methodology used to develop the budget system is that of "results-oriented management", whereby, in the formulation process, management objectives and outcomes are identified for each institution, administrative department, and executing unit, broken down by programmatic category; and (iv) the 2006 budget was formulated in the SIAFI in a multiyear, multi-source and multi-currency manner.
- 1.51 *Procurement management.* The biggest effort that Honduras has made to move forward with reform of the government procurement system has been through the Program for Efficiency and Transparency in Government Procurement (PET, 1059/SF-HO). The PET is intended to strengthen the government's capacity to supervise and manage public procurement functions, and includes adoption of a procurement policy and support for regulation and implementation of a new regulatory authority; the development of bidding documents and other standardized contractual instruments; and improved monitoring and training for procurement personnel. With this system in place, the transparency of procurement proceedings will allow use of the national procurement system in SWAps programs, where the use of national systems is essential.
- 1.52 Directly related to these institutional aspects is the adoption of an information system for managing procurement processes, with direct functionality with SIAFI. This will make it possible to record the corresponding commitments and accruals and to keep accounting records on government procurement and contracts, and is an integral part of efforts to improve transparency in public management. For this reason, the authorities have decided to design the electronic government procurement system in such a way that it provides the information needed for both internal and external management with modules for publishing the information on procurement, e-purchasing, and e-tendering. Achieving this objective will require a government decision making it compulsory for agencies to publish their procurement orders through the system (known as HONDUCOMPRAS), which at this point has its publication module partially in operation.
- 1.53 *The control environment.* Introduction of a new SIAFI will appreciably improve the capacity to exercise effective internal control by requiring agencies to manage their finances through a computerized system with built-in control mechanisms. Nevertheless, each agency will still be responsible for redesigning its own administrative procedures in order to comply with internal control objectives, which include preventing fraud and other crimes against the public administration. A body will also have to be established within the Executive Branch to promote the development of internal auditing.
- 1.54 To this end, the Executive Branch and the Court of Accounts (TSC) have held discussions on an institutional structure for the control of public funds that is in line with best practices and will overcome the existing weaknesses. The donor

community has expressed interest in helping the authorities establish this control mechanism as quickly as possible. The authorities have agreed on the gradual creation of a national system for controlling public funds that will coordinate internal and external controls. This agreement was communicated to the Bank in letters from the President's Office and the TSC in connection with the proposal for financing this program.

D. The Bank's strategy in the sector

- 1.55 The IDB country strategy with Honduras is in line with the poverty reduction strategy and is focused on three areas: (i) increasing the competitiveness of production; (ii) enhancing the development of human capital; and (iii) strengthening governance. The present program is in line with the Bank's strategy of strengthening governance by supporting the reforms needed to consolidate improvements in the efficiency, effectiveness and transparency of the public finances, on both the revenue and the expenditure side, through policy reforms that will modernize public management methods to reflect the principles of development effectiveness, through performance incentives.
- 1.56 *Related operations.* The Bank approved a poverty reduction support operation (1532/SF-HO) that includes an expenditure efficiency and effectiveness component designed to strengthen the financial administration system and project monitoring to generate a long-term budget planning strategy.
- 1.57 The Bank also approved a loan in support of poverty reduction and local development (Phase II, 1478/SF-HO), one objective of which is to improve the financial and institutional capacity of municipal governments so that they can better meet the needs expressed by the local population, including the adoption of new financial administration systems, process reengineering and modernization of municipal management, and the adoption of sound practices in the areas of physical, strategic, and participatory planning. SEFIN and the Ministry of the Interior (*Secretaría de Gobernación*), which is the executing agency for the 1478/SF-HO program, have agreed to coordinate actions relating to financial administration to bring the municipal systems into line with the guidelines issued by the new SIAFI that are being developed under program 1546/SF-HO and the two World Bank loans referred to above.
- 1.58 The program to improve health conditions (1619/SF-HO), which is being financed under the Bank's new performance-driven loan (PDL) approach, will make use of the management and impact indicators defined as part of the budget formulation process for fiscal year 2006.
- 1.59 Lastly, the Bank has approved—or is in the process of preparing—a series of technical cooperation operations that support the process of generating information that would be input for accountability and implementation of management capacity

within the central government: (i) with support from the Swedish Cooperation Agency, SEFIN is preparing a summary budget for 2005 and the same is expected for 2006 (ATN/SF-9083-HO), which will serve as an instrument for analysis and dialogue on performance between the State and the citizenry; (ii) a technical cooperation operation for the development of the National Public Investment System in SEFIN (ATN/SF-9741-HO), to support the plans-outputs-costs linkage; and (iii) support for the Ministry of the Presidency and SEFIN in developing an action plan for implementation of results-based management through the PRODEV A Account (in preparation). The program proposed in this document will be reinforced by Honduras's participation in PRODEV and by the activities that this PRODEV technical cooperation operation will finance, which takes into account the actions proposed in this document.

E. Program strategy and coordination with other donors

- 1.60 The establishment of the new SIAFI, the simultaneous preparation and presentation to Congress of budgets that include all revenues and expenditures, and the administrative modernization of the Finance Ministry are laying a solid basis for the future introduction of management by results, which requires reliable information and mechanisms to control public funds. The new SIAFI must be bolstered by reforms to the processes and procedures for handling the information it contains, and by a stronger legal and accountability framework for public financial management, greater transparency and improved mechanisms for monitoring and control, simplification of processes and procedures, and strengthening of the institutions charged with managing PRS targets. This will entail a thorough overhaul of the country's management model, towards one that bases decision-making on management effectiveness and on achieving the development goals set forth in the National Plan.
- 1.61 The proposed program will support this public management model through policy reforms aimed at: (i) day-to-day decision-making based on an institutional strategy; (ii) structuring of executing units so as to achieve results, through outputs that will determine the allocation of resources; (iii) decentralized decision-making and greater flexibility in the use of resources by making managers accountable for their results; and (iv) transparency in resource management. This approach will encourage a management style that focuses above all on effectiveness in the use of resources, and that allows the flexibility required to achieve results.
- 1.62 In addition, the desired comprehensive approach to public management requires a consistent and structured public procurement system that makes efficient use of public funds and that can serve as a catalyst for reforms, while at the same time being integrated into the financial administration system. In order to pursue the reform launched with the PET, the role of the National Office of State Purchases and Contracting (ONCAE) must be strengthened. A fully operational ONCAE, with appropriate staffing and strong leadership, will be key to speeding improvements in

the Honduran system and to strengthening its complementary linkages to other related efforts (for example those involving the TSC, the municipalities, the SIAFI, and other procurement agencies).

- 1.63 Lastly, the development of an institutional mechanism for coordinating the control of public funds through strengthened internal and external audit systems will improve efficiency with which public funds are used and will also help to minimize administrative corruption and increase transparency in public management. In each of these areas, the intent is to supplement the various investment programs by identifying and implementing institutional measures to modernize management and to begin the gradual shift to results-based management.
- 1.64 *Coordination with other donors.* The Bank has been working closely with the World Bank in the areas of financial administration and procurement, in preparation of the CFAA and the CPAR as well as in the design and implementation of investment programs (see Country Strategy). The World Bank has provided technical support for this program to ensure coordination and complementarity with the policy conditions of Poverty Reduction Credits II and III (PRSC) now in preparation. In the design of this operation the Bank has also been working with SIDA, which provided support for the design of the fiscal management strengthening program (1546/SF-HO) and supplied cofinancing, in the amount of US\$3.2 million, for the revenues subcomponent.

F. Lessons learned

- 1.65 The experience gained in preparing policy-based loan operations has demonstrated to the Bank the need for: perseverance and continuity in striving for sound policies that carry the consensus of the government and other members of the donor community and financing institutions; suitable technical assistance in planning and executing reforms; a solid government commitment to the process; and ensuring that, notwithstanding severe personnel and time constraints, operations are realistic in light of conditions in the country.
- 1.66 This program seeks to build upon these lessons by: (i) supporting a process that the government has undertaken with the support of the donor community; (ii) complementing reforms supported by technical cooperation programs that are being fast-tracked (1546/SF-HO and the World Bank programs); and (iii) supporting actions that reflect the incremental nature of public management reforms, and seek to support the beginning of a process that will extend over the medium to long term.

II. THE PROGRAM

A. Objectives and description

- 2.1 The objective of this program is to support the Government of Honduras in improving economic governance through a gradual reform of public management that will promote greater effectiveness and efficiency in the use of resources.
- 2.2 The policy reform matrix is divided into six action areas: (i) macroeconomic stability; (ii) institutional framework for results-based management; (iii) revenues: tax and customs administration; (iv) fiscal public financial management; (v) procurement management; and (vi) the control environment.

B. Structure of the program

1. Institutional framework for results-based management

- 2.3 This component will help develop an institutional structure for planning and management at the central and sector levels, consistent with a system for setting and evaluating goals, rather than simply focusing on means.
- 2.4 *Planning.* This subcomponent will be the first step in a process of integrating budget programming, real and financial, into the institutional environment, and linking this to medium- and long-term objectives and priorities. This calls for developing an institutional planning structure at the central and sector levels consistent with a system for setting and evaluating goals, rather than simply focusing on means. It will require coordination between the financial management offices and the Planning and Evaluation Units (UPEGs) and active participation of the executing units in formulating their budgets.
- 2.5 It is necessary to clarify that the coordination between the financial management offices of the ministries and the UPEGs is not just a matter of strengthening these entities but also the role of the executing units, which will have to take responsibility for formulating their draft budgets on the basis of established policies and directives. The financial management offices, under this system, would be responsible for compiling and consolidating those drafts and checking their consistency with previously defined policies. The conceptual framework of the new SIAFI incorporates these concepts, giving the UPEG the responsibility for setting targets and objectives, making the executing units responsible for introducing activities and their costs for the programs they execute, and assigning the financial management offices the responsibility of compiling the information in a draft budget.

- 2.6 In order to implement these reforms, the program will support the establishment of a Budget Policy Committee in each ministry, responsible for coordinating the formulation of the AWP and the draft budget. Each Committee will be comprised of the respective Deputy Minister and representatives of the financial management offices and of the UPEGs. The draft budget preparation process will be consistent with this coordination mechanism.
- 2.7 *Results-based management.* This subcomponent will support the gradual introduction of results-based programming and accountability, together with the output and outcome indicators and the definition of an action plan for gradual implementation of the new management methodology that will govern the operation of the institutions and will lay the foundations for more effective and efficient management of public resources, based on results.
- 2.8 The impact of this new management approach will make itself felt over the long term. As agencies put the new methodology into effect, they should be able to achieve substantial increases in their management efficiency and effectiveness, and in their ability to carry out development policies.
- 2.9 Because the new methodology is to be implemented gradually, the following conditions are proposed for the second tranche: (i) establishment of output and outcome indicators in four central government institutions; and (ii) submission of an action plan setting out the necessary elements for results-based management and its gradual implementation.
- 2.10 *Administrative reorganization of the Finance Ministry.* This subcomponent will enhance the administrative efficiency of SEFIN. This will entail simplifying the ministry's internal procedures, which will make for more efficient operations by eliminating duplication and overlap, and improving response times in the financial administration system itself, as well as in the administrative work of the units and offices of the ministry as a whole, relating to such things as certifications, exemptions, legal representation, judicial documents, and legal opinions. The goal is to achieve a 50% reduction in processing times and elimination of overlapping functions between the Budget Directorate, the Investment Directorate, and the Public Borrowing Directorate, and between the latter and the national treasury.
- 2.11 The program will support: (i) modification of SEFIN by-laws to adjust the organizational structure of the institution in accordance with the requirements of the Budget Act; and (ii) implementation of that new organizational structure, which is to eliminate overlapping functions, and simplification of the ministry's internal procedures.

2. Revenues: Tax and Customs Administration

- 2.12 *Tax and Customs Administration.* This component will overhaul the institutional framework of the Revenue Office (DEI), starting with its organizational structure, as the first step of a new process of sustainable development for the agency. In this regard and in the course of preparing this program, the Bank has been supporting the authorities in designing the organizational structure along the lines set out above (see paragraph 1.45), and the approval and implementation of the agreed structure is considered a condition for the program. Another key aspect in this area is the professional development of DEI human resources, with a personnel management approach that is being developed at the central government level.
- 2.13 This component contains three subcomponents: (i) overhaul of the institutional structure of the DEI, to initiate a new process of sustainable development in the agency and establish a career path system pursuant to the personnel management plan that is being developed for the central government; (ii) the Internal Revenue Division subcomponent, the purpose of which is to develop effective tools for supervising and auditing tax compliance by improving information availability and upgrading the computer applications used by the DEI; and (iii) the Customs Division subcomponent, to develop customs management rules and procedures that are efficient and compatible with the country's international commitments.
- 2.14 As a move toward sound management policies, the program will support modernization of customs regulations, among others, in order to achieve effective operational and oversight management in the context of Central American integration and of trade liberalization (WTO and FTAs). The program will also support, as a condition, improvements to management and information systems as they relate both to internal revenue and customs, since these are areas of key importance in terms of revenue collection, cost savings, transparency, and trade facilitation. (See Annex 1 for further details).

3. Public financial management

- 2.15 The program will support the institutional structure of the new SIAFI and the implementation of technical standards into the budget, accounting, treasury, and public borrowing subsystems that will allow differentiated resource administration procedures for agencies joining the programming, execution, and accountability system. These aspects will have to be built into the functional and information technology design of the new SIAFI before the new 2006 budget execution system is implemented. Output (performance) indicators will also be included in the budget, linked to impact indicators by sector, and the Master Treasury Account will be introduced: both are central aspects for ensuring that financial management is consistent with development goals as well as transparent.

- 2.16 *Budget.* The policy conditions in this subcomponent are intended to support methodological changes in the various stages of the budget process, through the definition of the budget standard that will strengthen programming, execution, control, and evaluation capacities as a prerequisite for gradual introduction of results-based programming and accountability. With the introduction of these new standards, the AWP and the budgets will be integrated into a single tool linking physical and financial variables in budget formulation, execution, and evaluation. Approval of technical budget standards that include the entire budget process will be a condition for each tranche of this section.
- 2.17 *Treasury.* Work in this area will involve developing a system for transforming the General Treasury (TGR) into the public sector's financial management office. It includes: (i) approving the standard for the treasury, with a financial programming methodology, a registry of beneficiaries, and the Master Treasury Account, and subsequently (ii) the elimination of all special bank accounts so as to give effect to the Master Account for the central government.
- 2.18 These steps will promote more efficient use of public funds through the Master Treasury Account, cutting by 50% the time taken to pay suppliers and contractors, substantially reducing short-term debt with the banking system, and eliminating the cost of maintaining multiple bank accounts, which will be closed.
- 2.19 *Public borrowing.* Under this subcomponent, the public borrowing system will be linked to the other systems that comprise financial administration, through: (i) the conceptual design of the SIAFI-SIGADE interface for domestic debt, guarantees and external debt; and (ii) the operational interface.
- 2.20 *Asset accounting and management.* The public accounting system will provide an integrated source of comprehensive, reliable, and timely economic and financial information on public management. This in turn will facilitate the preparation of monthly budget execution reports showing revenues and expenditures by institution, program, object of expenditure, and source of financing, as well as production of the Fiscal Account and the central government's financial statements within three months after the close of the fiscal year (currently takes more than six months).
- 2.21 With the new accounting system in place, reliable and timely information on economic and financial management by the central government and the decentralized administration will be available over the medium term. This means that, in the future, auditors will be able to verify the accuracy of the accounting data, and public officials can base their management decisions on comprehensive and timely economic and financial information. Fiscal management will become more transparent to the general public, and the Legislature will have information for evaluating the Executive's economic and financial performance. At the same time, combining data on economic and financial execution from the accounting system

with the results of physical execution will make it possible to determine costs, a fundamental element for measuring government efficiency.

- 2.22 Lastly, the program will equip the government with a permanent and up-to-date inventory of capital goods and consumables, showing stocks and values, for purposes of control and allocation of responsibilities. Additions and deletions will be interrelated with: (i) the procurement system; and (ii) financial records on expenditure budget performance. These objectives will be achieved through: (i) approval of accounting standards; and (ii) approval of standards for the administration of government assets, containing principles and definitions for recording additions and deletions and control of fixed assets, their valuation, and warehouse management.

4. Procurement management

- 2.23 The objective in this area is to consolidate progress to date and to speed reforms for bringing greater efficiency and transparency to the management of government procurement, by strengthening the role of ONCAE. The conditions under this component include: (i) activation of the ONCAE Advisory Committee for coordinating procurement policies; (ii) mandatory incorporation of information on government procurement opportunities on the ONCAE website; and (iii) approval of the conceptual design of the HONDUCOMPRAS system.

5. The control environment

- 2.24 The objective here is a comprehensive strengthening of controls over public funds to provide reasonable assurance that they are being handled, used, and invested in a manner consistent with efficiency, effectiveness, transparency, accountability, legality, probity and public ethics, and thus to ensure good governance. To this end, the TSC and the Executive Branch have reached agreement on the approach to controlling public funds, based on the following principles: (i) interdependence, coordination, and complementarity between external control (TSC) and internal control (Executive Branch); (ii) the Executive Branch must have a specialized technical unit for ensuring the effectiveness of the institutional process of internal control; and (iii) there must be an entity to coordinate internal and external controls. This agreement was communicated to the Bank in a letter dated 27 July, signed by the President of the TSC and the Secretary of State in the President's Office. The program intends to support the TSC's decision to institute the control system under the terms agreed with the Executive Branch.

C. Cost and financing

- 2.25 The program will be financed with a policy-based loan in the amount of US\$30 million from the Fund for Special Operations (FSO), to be disbursed in two tranches of US\$15 million each. The rationale for this approach is that the activities

to be supported involve primarily legal and regulatory reforms. The national authorities already have in hand the investment funds needed to develop the functional tools for the reform, and what they now need is the institutional structure for putting those tools to work in the context of a fiscal reform strategy aimed at improving governance, as called for in the PRS and the country strategy. This is a wide-ranging reform that goes well beyond SEFIN and will affect the manner in which the public sector performs its planning, budgeting, revenue collection, monitoring, oversight, and control functions.

- 2.26 The reforms under each tranche are regarded as sequential and are thus necessary for the full, if gradual, implementation of the proposed management methodology. For this reason, it is proposed that the loan should be disbursed in two equal tranches. Accomplishing the proposed reforms is considered essential to achieving the medium- and long-term management goals that the government has set for itself. In addition, the amount of the tranches makes it possible to assure considerable financing for the country, if needed to cover an unforeseen budget gap, in particular given the increase in oil prices, an exogenous variable that has significant repercussions for the country.
- 2.27 Lastly, the reform is supported at a key point in the process of modernizing financial management. Work on the 2006 budget began in mid-2005, making it essential to establish the technical standard for budget formulation. The new SIAFI went into production on 9 May 2006, and the standards governing key aspects of the system (treasury, accounting and budget formulation, and execution) have been established.

III. PROGRAM EXECUTION

A. Borrower and executing agency

- 3.1 The borrower is the Republic of Honduras. The executing agency is the Ministry of Finance (SEFIN), although there are other institutions that fall within the Executive Branch and under Congressional oversight that will have to do their part to ensure comprehensive implementation of the proposed management reform.
- 3.2 SEFIN will have the following responsibilities under the program: (i) to fulfill the program conditions; (ii) to help the other agencies involved in fulfilling the policy conditions; (iii) to provide reports and evidence of compliance with program conditions; and (iv) to receive the funds.

B. Execution period and disbursement schedule

- 3.3 The execution period will be 24 months, from the date the loan contract enters into force. The conditions for the first tranche should be fulfilled before the loan proposal is submitted to the Committee of the Whole.

C. Monitoring and evaluation

- 3.4 Program monitoring by the Government of Honduras will be the responsibility of SEFIN, through its Project Administration Unit, a unit created by a Ministry of Finance decree dated 23 September 2004. For the Bank's part, the program will be monitored by the project team in State and Civil Society Programs Division 2 (RE2/SC2) and the Integration, Trade and Hemispheric Issues Division (INT/ITD), with the support of the Bank's Country Office in Honduras. Monitoring compliance with the matrix conditions will be facilitated by fulfillment of the Annual Work Plans of IDB loan 1546/SF-HO and World Bank loans 3414 and 3939-HO. The program's impact evaluation will also be reflected in the achievement of the development objectives of those programs, and in the degree to which the reform is institutionalized in the future throughout the public management system. The evaluation of this program will need to consider the way in which the reforms financed under the investment programs approved in 2004 affected policy decisions, and the outcomes associated with the program proposed in this document.
- 3.5 The IDB and World Bank are updating the CFAA, identifying progress to date and the current baseline for each area of the action plan, as a means of efficiently measuring the effectiveness of the reform in achieving the proposed objectives. This update uses indicators from the financial administration indicators framework (Public Expenditure and Accountability Program—PEFA). The Results Matrix (Annex II) describes the expected results and impact indicators for the program, with their respective baselines. This set of indicators will serve as the basis for a final evaluation, to be conducted under terms of reference agreed by the borrower and the Bank, as well as for the Project Completion Report. The country systems, in particular SIAFI, contain information needed to measure the indicators established in the results matrix. Moreover, and as indicated in paragraph 3.4, the AWP and progress reports on the investment programs related to this policy reform will be part of the monitoring and supervision.
- 3.6 The borrower will be responsible for compiling all the data needed for program monitoring and evaluation. SEFIN's Project Administration Unit (UAP) will be in charge of monitoring compliance with the policy conditions established in the program. The authorities will cover the costs of compiling and processing those data, as part of the externally financed sector investments. This program and the related IDB and World Bank operations described in this document are expected to provide the funds needed to keep the relevant information up-to-date, for purposes of ex post monitoring of this program's results and impact. The country and the Bank will conduct periodic reviews of the program's progress at a minimum every six months. The authorities have not yet committed themselves to an ex post evaluation of this program.

D. Procurement of goods and services

- 3.7 Consistent with the procedures for sector loan disbursements, as set out in document GN-2001-2, disbursements will be made against fulfillment of the policy conditions described in the Matrix of Conditions (Annex I) and, based on the nature of the instrument, no procurement of goods and services is anticipated.
- 3.8 **External audits.** The Bank reserves the right to ask the borrower to submit financial reports on the use of loan resources, audited by independent auditors approved in advance by the Bank. To this end the borrower, through the Finance Ministry, will be responsible for: (i) maintaining accounting and financial records to identify the use of loan resources and to permit such external audits or checks as the Bank may request; and (ii) it will maintain specific, separate bank accounts for handling loan funds.

E. Execution period and disbursement schedule

- 3.9 The execution period will be 24 months. The loan will be disbursed in two tranches following verified compliance with the special contractual conditions.
- 3.10 Separate account. The Bank will deposit the loan funds in a separate account opened by the borrower.

IV. FEASIBILITY AND RISKS

A. Institutional feasibility

- 4.1 Implementing a performance-based management system entails a profound process of overhauling and modernizing public institutions in their capacity for planning, programming and administration, and it requires effective commitment from the highest political authorities in the country. Because of the change of government in early 2006, there was a risk of backsliding in the implementation of this process of transformation. On the contrary, the foundations for applying results-based management, which represents the conceptual, methodological, and information reform of public finance management, have had considerable impact, as recognized by the new authorities. The latter have reiterated the priority they attach to the reform and have agreed to continue expanding and deepening it.
- 4.2 This program is backed by a substantial body of institutional analysis including the CFAA, the CPAR, and the three loans now in execution for implementing the policy reforms stipulated in the matrix of conditions. Those documents, action plans, and investment programs reflect the consensus of the country's authorities and the donor community. SEFIN is the executing agency for the reforms supported by these programs.

B. Social and environmental impact

- 4.3 Given the nature of the operation, the project team anticipates no direct environmental or social impact.

C. Expected benefits

- 4.4 The introduction of performance-based management represents a substantial shift in the way government institutions operate in Honduras, for it means that in programming government activities priority should be given to meeting the needs of society more effectively. The capacity to have pertinent information has a positive impact on the capacity to design policies that reflect realistic development objectives with a clear idea of the financing needed to achieve them.
- 4.5 All of this will help in optimizing the allocation and use of public funds, and will put the Government of Honduras in a better position to access external financing, both through loans and through grants, in particular with respect to the funding requirements for the poverty reduction strategy. It will also help ensure better use of the resources that will become available upon achieving the completion point under the HIPC initiative.

D. Risks

- 4.6 One risk that was identified during program preparation relates to the institutional status of the Revenue Office (DEI), and the attendant uncertainties surrounding such key institutional aspects as its organizational structure and personnel system. To mitigate the risk that the organizational situation of the DEI poses for this program as well as for execution of loan 1546/SF-HO, the Bank team conducted several missions in 2005 and 2006 to help the authorities establish action priorities under loan 1546/SF-HO. These missions reviewed the DEI subcomponent of that program, validated its activities, and established a set of priorities based on the new circumstances. The new administration of the DEI has expressed a commitment to modernize the institution and transform it into an agency capable of collecting revenue effectively.
- 4.7 Lastly, designing this program during an election year was a risk to the continuity and sustainability of public management reforms. The program's objectives have been ratified by the new authorities, who negotiated the program on the basis of fully maintaining the goal sought. This reflects the State's political commitment to the reform and the support that the donor community has provided to ensure its continuity.

MATRIX OF POLICY CONDITIONS
PUBLIC MANAGEMENT REFORM PROGRAM (HO-0223)

Objective	First Tranche	Second Tranche
<i>I. Macroeconomic stability</i>		
	Macroeconomic conditions are consistent with program objectives	Macroeconomic conditions remain consistent with program objectives
<i>II. Institutional framework for results-based management</i>		
Planning: Develop an institutional structure for planning at the central and sectoral levels, consistent with a system for setting and evaluating goals, rather than simply focusing on means.	<p>1. Regulations have been issued setting out the establishment of a Budget Policy Committee in each ministry of state with responsibility for coordinating the formulation of the Annual Work Plan and draft budget, chaired by a Deputy Minister and comprising the Director of the Management Planning and Evaluation Unit, the Administrative Manager, and the Directors appointed.</p> <p>Means of verification: (i) Current ministerial order from the Ministry of Finance.</p>	<p>1. The process of preparing the draft budgets has involved at least three Ministries of State under the coordination of the respective Budget Policy Committees.</p> <p>Means of verification: (i) SEFIN reports describing the process of preparing the draft budgets for three Ministries of State.</p>
Results-based management. Gradual introduction of results-based programming and accountability, together with the respective regulatory framework and the general management methodology that will govern the functioning of the institutions and will lay the foundation for more effective and efficient management of public resources, based on results.		<p>1. Output and outcome indicators have been developed for at least four central government institutions.</p> <p>Means of verification: Budgets formulated for the respective year in the four institutions selected.</p> <p>2. An action plan has been prepared for the gradual implementation of results-based management, setting out basic components and requirements for executing the plan.</p> <p>Means of verification: Action plan approved by the Executive Branch.</p>

Objective	First Tranche	Second Tranche
Reorganization of the Finance Ministry. Enhance the administrative efficiency of the SEFIN.		<p>1. The bylaws defining SEFIN's new internal structure have been approved and implemented, eliminating overlapping functions, and internal administrative procedures have been simplified.</p> <p>Means of verification: (i) Current ministerial order to change the organizational structure; (ii) SEFIN report detailing staff appointments and budget in accordance with the approved structure; and (iii) streamlining report (reduced steps and time) for a specific activity identified in the administrative simplification proposal.</p>
III. Revenues: Tax and Customs Administration		
Revenue Office: Overhaul the institutional structure of the DEI, to begin a new process of sustainable development for the agency.	<p>1. The organizational structure of the DEI has been approved and is in effect.</p> <p>Means of verification: (i) ministerial order approving the organizational structure of the DEI published in the Official Gazette.</p>	<p>1. The DEI's organizational structure has been implemented.</p> <p>Means of verification: (i) the DEI's manual of duties and responsibilities has been approved by its Director.</p> <p>2. A plan for the management of DEI staff has been approved and is being implemented based on the pilot methodology that the government is seeking to apply at the central level.</p> <p>Means of verification: (i) SEFIN report; and (ii) report detailing staff allocations and budget in accordance with the staff management plan.</p>
Internal Revenue Directorate: Develop effective tools for the DEI to carry out its responsibilities for supervising and auditing tax compliance	<p>1. A work plan has been mapped out to (i) update initial balances on the current accounts of large and medium-sized taxpayers currently entered in E-TAX; (ii) complete migration to E-TAX of all information now contained in the SIT system, and deactivate that system permanently; (iii) capture and incorporate into databases the stock of outstanding tax returns.</p>	<p>1. Balances entered in E-TAX have been updated and information has been transferred to that system for large and medium-sized taxpayers; the transactional operations of the SIT have been deactivated</p> <p>Means of verification: (i) On-site inspection</p> <p>2. The design of the E-TAX audit module has been approved.</p>

Objective	First Tranche	Second Tranche
	<p>Means of verification: Work plan approved by the Director of the DEI.</p> <p>2. The 2006 audit plan for internal taxes has been approved.</p> <p>Means of verification: (i) audit plan approved by the Director of the DEI.</p>	<p>Means of verification: Design approved by the Director of the DEI.</p>
<p>Customs Directorate: Develop customs rules and procedures that are efficient and compatible with the country's international commitments.</p>	<p>1. The Uniform Central American Customs Code (CAUCA) has been approved by the Council of Ministers for Central American Integration.</p> <p>Means of verification: Minutes of the Council of Ministers for Central American Integration.</p>	<p>1. The CAUCA has entered into force for Honduras, and the legal instruments and reforms identified in the review have been approved.</p> <p>Means of verification: (i) CAUCA published in the Official Gazette.</p> <p>2. A conceptual model has been designed for the new customs management system that includes operational and inspection procedures for: (i) control of arriving and departing shipments; (ii) national customs transit; (iii) retained imports; (iv) retained exports; and (v) customs warehouse control.</p> <p>Means of verification: (i) design approved by the Director of the DEI.</p>
IV. Public Financial Management		
<p>Budget process: Develop methodologies for budget formulation, analysis, amendment, programming, and evaluation, in support of results-based management</p>	<p>1. Technical Standard for the budget subsystem has been approved, including:</p> <ul style="list-style-type: none"> -Budget classifiers for the national public sector. -General and common methodology for formulating budget policy -Budget preparation manual for the central government, decentralizing the process to the executing unit level; clear definition of output and impact indicators. 	<p>1. Technical Standard for the budget subsystem has been approved, including manuals on:</p> <ul style="list-style-type: none"> -Central government draft budget analysis, with general/standard analysis methodologies and special features for agencies that join the results-based management system. Includes the respective formats and reports. -Budget amendments for central government, covering the general system with special features for agencies that join the results-based management system. Includes the respective formats and reports.

Objective	First Tranche	Second Tranche
	<p>-Multiyear budgeting methodology consistent with the budget preparation methodology, including the respective formats and reports.</p> <p>Means of verification: Ministerial Decision issued by the Minister of Finance</p>	<p>-Budget execution evaluation, covering the general system with special features for agencies that join the results-based management system, and design of a catalogue of output and impact indicators for monitoring purposes. Includes the respective formats and reports. (Technical Standard Approved).</p> <p>Means of verification: Ministerial Decision issued by the Minister of Finance.</p>
<p>Treasury. Develop a system for transforming the General Treasury (TGR) into the financial management office for the public sector.</p>	<p>1. Technical Standard has been issued for the Treasury, with principles and procedures for:</p> <p>-Financial programming for the central government and its linkage with the programming of execution, including the respective formats and reports.</p> <p>-Operation of the Master Treasury Account for the Public Sector, including procedures for recording resources and payments (electronic and conventional), with the respective formats and reports.</p> <p>-Creation and updating of the registry of public-sector beneficiaries, including the respective formats and reports.</p> <p>-Automatic banking reconciliation for the public sector, including the respective formats and reports.</p> <p>Means of verification: Ministerial Decision issued by the Minister of Finance</p>	<p>1. Special bank accounts in domestic currency have been eliminated, except for those expressly authorized by the Budget Act regulations.</p> <p>Means of verification: Treasurer's Certification that special bank accounts not authorized by law have been eliminated; report on existing accounts.</p>
<p>Public borrowing. Support the institutional structure of the relationship between the public borrowing system and the other systems that comprise the financial administration</p>	<p>1. The development of the conceptual model for the SIGADE-SIAFI interface has been approved.</p> <p>Means of verification: Note from the Undersecretary of Public Borrowing approving the conceptual model.</p>	<p>1. The SIGADE 5.3 / SIAFI interface is operational.</p> <p>Means of verification: (i) reports produced by the Directorate of Public Borrowing of SIGADE; (ii) reports produced by SIAFI.</p>

Objective	First Tranche	Second Tranche
<p>Asset accounting and administration. Provide an integrated system for comprehensive, reliable and timely economic and financial information on public management; and a permanent and up-to-date inventory of capital goods and consumables, showing stocks and values, for purposes of control.</p>	<p>1. Technical Accounting Standard has been approved for:</p> <ul style="list-style-type: none"> -Central government expenditure budget execution. Includes the respective formats and reports. - Central government revenue budget execution. Includes the respective formats and reports. - Government Accounting Manual. <p>Means of verification: Ministerial Decision of the Minister of Finance.</p>	<p>1. Technical accounting standard has been approved, covering :</p> <ul style="list-style-type: none"> -Conversion tables for revenues and expenditures, for general accounting purposes. -Central government accounting statements <p>Means of verification: Ministerial Decision of the Minister of Finance</p> <p>2. The Technical Standard for managing government assets has been approved and contains the principles and definitions for recording additions and deletions and control of fixed assets, their valuation, and warehouse management.</p> <p>Means of verification: Ministerial Decision of the Minister of Finance.</p>
<i>V. Procurement Management</i>		
<p>Procurement: Institute a government procurement system that is linked to financial administration systems and can bring efficiency and transparency to the procurement process.</p>	<p>1. The ONCAE Advisory Committee is operational.</p> <p>Means of verification: (i) Presidential order appointing the members, published in the Official Gazette; (ii) minutes of meetings of the Advisory Committee.</p> <p>2. Legally binding rules have been approved requiring that procurement information be posted at the official ONCAE website.</p> <p>Means of verification: Executive Decree.</p>	<p>1. The conceptual design of the government procurement system has been approved.</p> <p>Means of verification: Design approved by the Director of ONCAE.</p>

Objective	First Tranche	Second Tranche
VI. Control environment		
<p>Comprehensive strengthening of control over public funds: Support establishment of the National System for Control of Public Resources and improve all its elements and components and make them operational.</p>	<p>1. Agreement has been reached on the manner in which public funds are to be controlled, including at least the following features:</p> <ul style="list-style-type: none"> (i) Interrelationship, coordination and complementarity between external control (TSC) and internal control (Executive Branch); (ii) The Executive Branch has a specialized technical unit to oversee the effectiveness of agencies' internal control; (iii) A body for the coordination of internal and external control is in place. <p>Means of verification: letter signed by the Secretary of State in the President's Office and the President of the TSC specifying the form of control over public funds.</p>	<p>1. The TSC has reissued the regulations that set out the internal control system to be implemented by the Executive Branch.</p> <p>Means of verification: Administrative Order of the TSC published in the Official Gazette.</p>

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

RESOLUTION DE-___/06

Honduras. Loan ____/SF-HO to the Republic of Honduras
Public Management Reform Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a public management reform program. Such financing will be for the amount of up to US\$30,000,000 or its equivalent in other currencies, except that of Honduras, which is part of the Bank's Fund for Special Operations, and will be subject to the Financial Terms and Conditions and the Special Contractual Clauses of the Project Summary of the Loan Proposal.

(Adopted on _____ 2006)