

## **PUBLIC SECTOR REFORM PROGRAM**

(HO-0101)

### **EXECUTIVE SUMMARY**

**BORROWER:** Government of Honduras

**EXECUTING AGENCIES:** The Presidential Commission on Modernization of the State, represented by the program coordinating unit; and the Ministry of Finance, represented by the Executive Secretariat of the Consultative Commission on Privatization. These executing agencies will carry out the program with the participation of the institutions indicated in chapter III, part C.

**AMOUNT AND SOURCE:**

IDB:	US\$155 million
IDA:	US\$ 55 million
Total IDB/World Bank Program:	US\$210 million

**FINANCIAL TERMS AND CONDITIONS:**

Amortization period:	40 years, including a 10-year grace period
Disbursement period:	3 years
Interest rate:	1 percent during the grace period; 2 percent for the remaining 30 years
Inspection and supervision:	1 percent
Credit fee:	0.5 percent

**OBJECTIVES:** The basic objective of the public sector reform program is to support the modernization process that the government has been implementing since 1990 through the State modernization program (PME). The program proposed in this report seeks to modernize the public sector and eliminate structural problems that cause recurrent fiscal imbalances. This involves rethinking the State's role in the economy as follows: (i) transferring the provision of public goods and services in part to the private sector, concentrating the State's activity on setting policies and standards, and regulation; (ii) restructuring state institutions to help them adapt to trends in the new market economy and make them more efficient; (iii) reducing the size of the State through a reduction in public employment; and (iv) rationalizing economic policy and investment planning decisions, also in line with the new trends in the economy.

**DESCRIPTION:**

The program has three components: (a) reform of public services, consisting of restructuring principal services through privatization and concessions. The private sector is to be given a role in the telecommunications and aviation sectors and the distribution of electricity upon program completion. A strategy is also to be developed to introduce private sector participation in ports; (b) administrative reform, which includes: (i) institutional reform in four sectors (education; health and social services; natural resources; and infrastructure and communications) and the rationalization of the central ministries (Economic Affairs, Finance, and Planning); and (ii) rationalizing the public employment and pay regime; and (c) public administration reform, which includes: reform of financial management and investment planning. This program would be cofinanced with the World Bank.

Technical cooperation funding is being included to assist the Government of Honduras in defining and implementing reforms to modernize the State, support the public sector reform program, and strengthen the government's capacity for program execution and fulfillment of conditions precedent. This technical cooperation program for US\$16.7 million would be cofinanced with the World Bank, as follows: US\$5 million would be provided by the IDB, US\$9.6 million by the IDA, and US\$2.1 would be contributed by the Government of Honduras. (See Annex III-1)

**ENVIRONMENTAL  
CLASSIFICATION:**

The Environment Committee, at its meeting of May 11, 1995, classified this as a Category II operation and recommended that, given the size of the operation, the regulatory framework for the environment and natural resources be reviewed (see chapter III, part I).

**IMPACT ON POVERTY:**

Given its nature, the program does not fall within the poverty-reduction criterion indicated in paragraph 2.15 of the report on the Eighth Replenishment.

**BENEFITS:**

This program is key to restoring and maintaining macroeconomic stability and improving efficiency in the state apparatus. It will help make the public sector smaller and more efficient, and will allow public services to be provided to the population more efficiently and at a lower cost by the private sector. This will correct structural weaknesses which have caused difficulties in fiscal management, particularly on the expenditure side. Through the parallel technical cooperation funding, the program will also support the beginnings of social security reform to ease fiscal pressures on the central

government. The program is based on a legal framework that will allow for far-reaching, sustainable reform.

**RISKS:**

The proposed operation poses three potential risks. The first relates to the political commitment that the reforms require. It is attenuated by the fact that the administration has demonstrated its commitment by implementing even reforms carrying a high political cost such as reducing employment and the fiscal deficit, and the submission and passage of laws through Congress to reform public enterprises through privatization and concessions. The second risk relates to the scarcity of skilled personnel and technical resources to implement the reform. To offset this risk, a parallel technical cooperation project has been designed. The third risk relates to the complexity of executing and monitoring the program. The parallel technical cooperation project includes funding for a consultant, located in Honduras, to carry out the monitoring. This program monitoring would help avoid slippage (see chapter III, part G). Significant progress has already been made on the program, so that proper execution is assured. By the time the Boards of the two Banks have approved the operation and the first tranche is under way, the most important laws for promoting the modernization process will already have been passed (see Annex I-1) and most of the conditions precedent to the first tranche fulfilled (see chapter III, part B).

**THE BANK'S  
COUNTRY STRATEGY:**

The Bank's strategy for Honduras seeks: (i) to eliminate financial constraints by supporting programs to restore the government to a sound footing; (ii) to make investment more productive by supporting programs in privatization, promotion of private investment, improvement of government efficiency, and promotion of exports and work training; and (iii) to develop human capital by promoting social projects. The proposed program is essential to the achievement of this strategy.

**EXCEPTIONS TO  
BANK POLICY:**

It is recommended that competitive bidding not be required for imports of petroleum and its derivatives in amounts greater than US\$5 million (see chapter III, part D).

It is recommended that the period for reimbursement of pre-contract expenses be nine months rather than six (see chapter III, part D).

Executive Summary

Page 4 of 4

**SPECIAL  
CONTRACTUAL  
CONDITIONS:**

The loan contract will contain, in addition to the general contractual conditions applicable to this type of loan, those set out in the policy matrix and the policy letter transmitted by the President of Honduras and the related action plans, which are available for consultation in the technical files of Region 2.

## I. FRAME OF REFERENCE

### A. Macroeconomic overview

- 1.1 Honduras, one of the poorest countries in Latin America, posted per capita GDP of just US\$659 in 1994. Its economy is highly dependent on the exterior, being based on a small number of export goods. Coffee and bananas account for 43 percent of total exports. Agriculture generates 20 percent of GDP; mining and manufacturing 30 percent; and services, including the government, the remaining 50 percent.
- 1.2 After a decade of economic instability characterized by fluctuations in GDP, high unemployment, large fiscal and balance of payments deficits, and an increasingly overvalued currency, in 1990 the government initiated a stabilization and structural adjustment program, deregulating prices and trade. The stabilization program is supported by the IMF's Enhanced Structural Adjustment Facility (ESAF) and several adjustment operations financed by the IDB and the World Bank. The objective is to reduce fiscal imbalances and increase private sector participation in the economy. Important changes were achieved during the first years of implementation of the stabilization program, as reflected in the recovery of GDP and reductions in the fiscal deficit and inflation. In accomplishing these results, the government took major steps such as lifting exchange controls, carrying out customs tariffs and tax reform, deregulating the financial system, and abolishing some controls and subsidies on agricultural prices.

	1990	1991	1992	1993	1994	1995 (p)
1. Growth of GDP (%)	0.1	3.3	5.6	6.1	-1.5	4.0
2. Fiscal deficit	5.9	2.2	3.7	10.1	7.5	4.5
3. Balance of payments - current account deficit <u>1/</u>	5.1	5.9	8.0	10.8	7.5	2.6
4. Inflation (Dec/Dec)	23.3	33.9	8.8	10.7	22.0	25.0
5. External debt (US\$M)	37.14	383.0	3593.0	3865.0	4172.0	3823.0
6. Gross international reserves (US\$M)	43.0	113.0	205.0	160.0	205.0	260.0

Source: Central Bank of Honduras, IDB/ESDE.  
 (p) Provisional.  
1/ Excludes transfer.

- 1.3 As can be seen in the preceding table, in 1993 a setback in the economy occurred which is reflected in the 1994 principal economic indicators. The fiscal deficit widened considerably in a departure from the agreement with the IMF. The situation worsened in 1994 as a severe drought pushed down productive activity and the production of electricity, with repercussions on the fiscal deficit (7.5 percent) and the balance of payments. In October 1994 the Legislative Assembly approved a package of measures to put the country back on track towards adjustment. The IMF analyzed these measures and expressed its agreement with them as fundamental to reducing the fiscal deficit, and in January 1995 approved the ESAF for a second year in the amount of US\$36 million.
- 1.4 The external debt is one of the country's main problems, not only because of its amount, but also because of the service it generates. In 1994, the debt totalled US\$4,172 million (128 percent of GDP), and debt service represented 36 percent of exports and 12 percent of GDP. Fifty-two percent of the debt is multilateral in nature, and the IDB, the World Bank and CABI are the major creditors.
- 1.5 In recent years, the government has begun several initiatives to reduce the debt overhang. The debt to the Paris Club countries was rescheduled on very favorable terms in 1990, and then again in 1992 based on the Trinidad agreement. Most of the payments outstanding to the Paris Club creditors were to be made by the end of 1994, with the remaining amounts to be cleared in 1995. An attempt is currently being made to reschedule debt with several Latin American countries and to reduce the debt to commercial banks. Honduras is eligible only for concessional loans from the IDB. Since 1991, all World Bank loans have been made with IDA funds and in the last three years, Honduras has received flows equivalent to 90 percent of interest payments made to the World Bank. Funds were obtained recently from the Netherlands to pay part of the country's debt service to the World Bank. The IDB is supporting the government in developing a short and medium-run strategy to ease the pressure placed by payments of interest and principal on fiscal accounts and the balance of payments and in examining debt conversion mechanisms. In addition, the Bank is coordinating a strategy with CABI to reduce Honduras' debt to that institution. These actions, together with the proceeds from concessions to be granted for telecommunications services and energy distribution, will serve to reduce external debt pressure (see Annex I-2).
- 1.6 Despite the improvement in the balance of payments, Honduras will continue to require sector loans from the IDB and the World Bank, given its high debt service payments and the need to build up international reserves. In October 1995, the IMF lowered the target amount of reserves from US\$185 million to US\$85 million and raised the 1996 target from US\$100 million to US\$220 million as a temporary adjustment measure in view of falling world coffee prices and delays in disbursements of sector loans providing balance of

payments support. The balance of payments support from the IDB and the World Bank is crucial, and without it Honduras would face a shortfall of close to US\$95 million. That figure equals projected disbursements under the Bank's sector loans (energy, agriculture, public sector reform, and water and sanitation), plus savings on IDB debt service implicit in the public sector reform program.

**B. The public sector**

- 1.7 The public sector is excessively large and performs activities that could be carried out more efficiently by the private sector. It has a highly complex administrative structure that includes agencies in need of being modernized and institutions and activities with overlapping or complementary functions that need to be coordinated.
- 1.8 If macroeconomic, fiscal and balance of payments stability is to be restored, reduction of government expenditure is crucial. Income as a percentage of GDP compares favorably with other countries in the region, while expenditure in the nonfinancial public sector in 1993, at 36.4 percent of GDP, compares unfavorably. Operating costs represent one third of this expenditure, and public payroll costs 8.2 percent of GDP. The problems are accentuated by high public investment, which represented 12.6 percent of GDP and generates a high external debt service cost.
- 1.9 Public services in the energy, communications and transport, and water and sanitation sectors are provided by the State on a centralized and monopolistic basis. Investments in these areas have been made largely with borrowed funds, and public utilities have occasionally been excessively large, leading to high operating and maintenance costs.
- 1.10 Due to the foregoing, almost 50 percent of the public sector external debt is concentrated in the public enterprises and SECOPT, the latter due mainly to the expansion of airports (ENEE, 22.4 percent; HONDUTEL, 4 percent; SANAA, 5.9 percent; ENP, 1 percent; and SECOPT, 16 percent). Close to 30 percent of the public sector debt is attributable to the Central Bank and the Ministry of Finance, part of it in connection with the aforementioned public utilities.

Table 3. Public Investment (%)			
Year	1993	1994	1995 *
Central government of which SECOPT	49.2 40.1	22.0 17.4	35.7 22.0
Public enterprises	25.9	52.2	37.9
ENEE	15.0	14.0	8.9
ENP	2.7	1.7	1.6
HONDUTEL	4.7	30.1	16.9
SANAA	3.5	6.4	10.5
Rest of government of which FHIS	24.9 7.2	25.8 4.2	26.4 6.2
Total	100.0	100.0	100.0

\* Budgeted

- 1.11 Currently, the delivery of public services is characterized by a lack of competition and an inefficient legal framework, which have given rise to deficiencies such as poor coverage, poor service quality, tariff distortions, maintenance problems, high investment costs, and external indebtedness. The public utilities operate as national monopolies, performing simultaneously the functions of service delivery, policy-setting and regulation.
- 1.12 The public sector is overstaffed, particularly at the lower levels of the pay scale. The employment structure is inadequate and management is poor. Position grades and classifications do not take account of qualifications and degree of responsibility, there is no evaluation system, and training programs are limited. Since 1980, growth in public employment has accelerated, beginning to decline in 1992. Most of the growth occurred in the central government, especially in education and health, where serious problems in the distribution of human resources are found. Temporary employment also grew significantly. There are many public employees with low educational levels and minimal training. In addition, public sector employment is characterized by redundant activity, high absenteeism, and jobs with no clearly defined duties.
- 1.13 Pay has been eroded, especially at the upper levels of the pay scale. The civil service classification system is out of date and the salary scale is obsolete. This has led to the establishment of new employment and salary systems with preferential treatment. In the decentralized institutes, the situation is similar.
- 1.14 Honduras is undergoing a process of structural reform to give the economy a market orientation with a leading role for the private



sector in production. A series of economic policy measures have been adopted, including deregulating prices, eliminating subsidies, maintaining the currency at market value, and removing obstacles to foreign trade. The government wishes to introduce institutional reforms to make the administrative structure of economic policy management more responsive to new economic needs and to move ahead with free market policies.

- 1.15 Accordingly, plans call for reforming the structure of economic policy administration, now divided into three ministries (SHCP, SEC and SECPLAN), with complementary functions that are not adequately coordinated, duties that are mixed and sometimes overlapping, and functions that are not performed or that in some cases have become obsolete or are redundant. The Ministry of Economic Affairs covers development subsidies, regulation of and controls and restrictions on domestic and foreign trade, censuses and statistics, and transport planning, as well as oversight of compliance with international agreements and treaties. The Ministry of Planning covers, *inter alia*, the preparation of development plans and investment programs, international technical cooperation, and land tax registers. Many of the functions of these two ministries reflect the interventionist policies of the 1970s and are now obsolete. Moreover, the Ministry of Economic Affairs lacks instruments and authority to adequately discharge its responsibility to ensure the competitiveness of domestic production, expansion of export markets and economic integration, and application of foreign exchange, tariff and tax policy.
- 1.16 The investment planning system needs to be coordinated with the financial system, the purchasing system decentralized, and the auditing and control system reviewed to improve efficiency. Most of the foregoing activities would be supported by the program, as described in chapter II.

C. Government activity

- 1.17 The government recognizes that long-term macroeconomic stability and sustained economic growth require far-reaching reform of the State to eliminate structural problems and reduce the fiscal deficit and the external debt. Since 1990, the IMF through the ESAF, the World Bank, and the IDB with its sector reform programs, which would be joined by the proposed program, have been supporting the government in this reform. With this support, private sector participation is being expanded and services decentralized, which will result in more efficient income generation and a better use of outlays.
- 1.18 The government's progress in the state modernization program can be seen in several activities, the principal of which are: (1) establishment in 1992 of the Presidential Commission on Modernization of the State (CPME) with legal authority to designate, coordinate and monitor execution of the reform; (ii) establishment of the

consultative committee on privatization; (iii) passage of Law 135/94, on the restructuring of revenues and reduction of expenditure in the public sector. This law includes a series of critical activities for the administrative reform program, especially in the area of rationalizing payroll costs and downsizing employment. Reduction of personnel is already in process, with about 5.7 percent of public employment being cut in 1995 in the central and decentralized administration, of the goal of 10 percent which the government has set for itself during execution of the program; (iv) passage of the electricity sector law, which lays down a series of measures to restructure the sector and increase private sector participation. Some aspects of this law need to be modified (see the section on the electricity sector in chapter II); (v) approval of the Natural Resources Sector Act; (vi) approval of the Telecommunications Sector and HONDUTEL Reform Act; (vii) institutional reform programs in various ministries, enterprises and decentralized institutes, under the coordination of the CPME, and commencement of implementation of the reforms in some of these institutions. Among these reforms, those promoted with the support of the two banks in the natural resource sector and the electricity subsector should be noted; (viii) action to reform the procurement system, including passage by Congress of a decentralized system. On the basis of Law 135/94, the central procurement office was eliminated; (ix) development of plans to establish an integrated financial system; (x) issuing of the executive decree approving institutional reform programs for agencies subject to the reform; (xi) approval of the Financial Institutions Act; and (xii) preparation and submission to Congress of the new Public Administration Act to establish a complete and updated legal foundation for the modernization process.

- 1.19 On the revenue side, the government has made significant progress in important activities such as abolishing the temporary importation regime, establishing a one percent tax on assets, expanding the sales tax base, increasing gasoline prices and electricity rates, eliminating subsidies in the agricultural and industrial sectors, and reducing the oil and fuel subsidy. Also, the Tax Code has been submitted to Congress.

**D. IDB actions in support of Modernization of the State**

- 1.20 In the case of energy, with the support of the energy sector program and this operation, a more competitive environment is being created in both generation and distribution. Similarly, in the case of the water and sanitation sector, through the sector project in preparation by the IDB, support will be provided for the decentralization of service delivery. In the social sectors, the Bank will support health and education reforms which are now in preparation. For telecommunications, aviation and ports, the government, supported by both Banks through the public sector reform program is developing a sector policy aimed at privatizing or granting concessions for some services. The financial sector is

also being supported through the multisector credit program. With these reforms, it is anticipated that the public external debt situation will improve and the public sector will be relieved of a major investment burden (see Annex I-3). Supplementing these activities, in May 1995, the Bank's Board of Executive Directors approved a technical cooperation project to reform the tax administration, in order to improve collection capacity and reduce evasion.

**E. The Bank's strategy**

- 1.21 The IDB's strategy for Honduras seeks: (i) to eliminate financial constraints by supporting programs to restore the government to a sound footing; (ii) to make investment more productive by supporting programs in privatization, promotion of private investment, improvement of government efficiency, and promotion of exports and work training; and (iii) to develop human capital by promoting social projects.
- 1.22 The program's strategies having highest priority are support for public sector reform and restoring the government to a sound footing, reducing the fiscal deficit and the external debt. The program would bring progress in opening up to the private sector those areas having a high potential for fiscal savings and debt reduction. In addition, it lays the groundwork for institutional reform in the social sectors (see chapter II).
- 1.23 The program initiates a second structural adjustment phase that the Government of Honduras has been promoting with the support of the IDB and the World Bank under the loans indicated in part D. The first two are cofinanced by the IDB and the World Bank and the latter financed by the IDB. The program is also supplemented by other activities the IDB is preparing for modernization of the State, such as the judiciary reform project, legislative branch reform project, water and sanitation sector reform, intermediate and technical education reform, health sector reform, and the aforementioned technical cooperation for tax administration reform (see Annex I-3).

## II. THE SECTOR PROGRAM

### A. The State modernization program

- 2.1 The government is carrying on an extensive State modernization program which takes in the three branches of the State. The reform is coordinated by the CPME and has been supported by the legislative branch through the Public Sector Revenue Restructuring and Expenditure Reduction Act passed in October 1994 (Law 135/94) and several other laws on reform which have been approved or are being considered by Congress.
- 2.2 The program seeks to support private sector participation by privatizing and granting concessions for major public services, and to reduce functional overlap by restructuring key institutions. It also seeks to rationalize the employment and pay regimes.
- 2.3 The reform takes in most of the State ministries (SHCP, SEC, SECPLAN, SRN, SEP, SGJ, SECOPT, SRE, STPS, and SSP) and several of the public enterprises (HONDUTEL, ENEE, SANAA, and ENP), and decentralized institutes (JNBS, PANI, IHCAFE, IHRM, FHIS, IHSS, INFOP, EDUCREDITO, and IHMA) and bodies supporting the legislative branch and judiciary (the Auditor General's Office, the Attorney General's Office, and the procurement office). The objectives of this reform are to make the State more efficient by reducing the government's size and expenditure, improving the revenue collection system, and making public administration more efficient. To achieve this, it seeks to reform and privatize or grant concessions for public services, restructure institutions and employment; streamline and restructure the revenue collection system; and streamline financial management, procurement, and internal and external controls.

### B. The public sector reform program

#### 1. Objectives

- 2.4 The public sector reform program cofinanced by the IDB and the World Bank is the cornerstone of the government's State modernization program (PME) described in part A above. It is based on the need to rethink the role played by the State in the economy, recognizing the need to transfer the delivery of public services and goods to the private sector and seeking to concentrate State activity on setting policies and standards and regulation.
- 2.5 The program's objectives are consistent with those of the PME and seek to make the State more efficient and ease its fiscal and debt burden by reducing its size and expenditure. This would be achieved by downsizing the public sector as follows: (i) eliminating duplication and unnecessary functions, reducing employment

and giving the private sector a role in the delivery of public services; and (ii) reforming the investment planning and expenditure allocation process. Rationalization will make it possible to reallocate scarce fiscal resources to priority areas, thus making the public sector more responsive to the needs of society. The program also seeks to ensure that the population benefits from a more efficient delivery of public services.

## 2. Program focus

- 2.6 The program focuses on substantive reforms that will ensure sustainability, have a significant impact on reduction of the fiscal deficit and the public debt, and in turn bring about a more competitive system to improve efficiency in the delivery of public services. Within these reforms, privatizing and granting concessions for services play a basic role by enabling the private sector to participate in providing more efficient service at competitive costs and help meet the substantial investment requirements without representing increased cost to the government. The transfer of services to the private sector will generate fresh resources to clear the debt.
- 2.7 The reduction in employment provided for in Law 135/94 will have a significant fiscal impact. To ensure its sustainability and the efficiency of state officials, activity concentrates on rationalizing the employment and pay regime and on administrative and control measures. (See the section on rationalization of employment and pay in this chapter.)
- 2.8 The program also seeks to rationalize the state ministries accounting for the greatest public expenditure (Education, Health, Public Works, and Transport and Natural Resources) and to streamline the operations of ministries responsible for investment policy and planning (Economic Affairs, Finance, and Planning).
- 2.9 To determine the program's fiscal impact, an exercise was conducted to calculate fiscal savings. The program's impact is presented in the following table:

Table 4. Fiscal Impact		
Public sector reform activities	Fiscal impact	
	US\$ millions	% of GDP
I. <u>Public services reform (privatization, concessions)</u>	<u>48.5</u>	<u>1.30</u>
1. Telecommunications	31.9	0.86
2. Civil aviation	16.6	0.44
3. Ports	n/a	n/a
4. Energy	1/	1/
II. <u>Administrative reform</u>	<u>44.0</u>	<u>1.20</u>
<u>Institutional reform</u> (excludes employment)	10.8	0.29
1. Education Ministry	1.9	0.05
2. Health Ministry	2.6	0.07
3. Communications and Transport Ministry (excludes civil aviation)	2.3	0.06
4. Natural Resource Ministry	0.4	0.01
5. Decentralized institutes	3.6	0.10
<u>Rationalization of Employment</u>	33.2	0.91
<u>TOTAL</u>	<u>92.5</u>	<u>2.50</u>
1/ Figures pending the results of the study in progress under the energy sector program.		
Source: Estimates by the mission in collaboration with the sector consultants in the field.		

2.10 As can be seen from the table, the program would contribute to restoring fiscal balance by generating ongoing savings approaching 2.5 percent of GDP. This would help the government significantly in facing the fiscal consolidation goals agreed with the IMF. The measures of greatest impact are those for the restructuring of telecommunications, representing a fiscal impact of 0.86 percent; institutional restructuring of civil aviation and the granting of airport concessions at 0.44 percent; and rationalization of employment at 0.91 percent. (For details, see Annex II-1.)

2.11 Although fiscal savings attributable to institutional restructuring in the social ministries and the ministries of Economic Affairs, Planning and Finance are not large, the first shows very significant impact due to reduction in employment; and in the second, improved efficiency due to planning, timing and control of expenditure has great influence on fiscal impact. In addition, the restructuring of the social ministries lays a very important foundation for institutional reform in support of the sector reform planned.

#### C. Program components

2.12 The program has been designed in three components: reform of public services, administrative reform and reform of public administration, and a parallel technical cooperation project aimed

at supporting implementation of the reforms. The program's components are described below:

1. Reform of public services

- 2.13 This component focuses on restructuring major public services to free the State of a considerable burden in terms of public debt, investment and operating costs, through greater private sector participation. The objective is to promote more efficient delivery of telecommunications, electricity, airport and port services (see the section on the public sector in chapter II).

a. Telecommunications

- 2.14 The Honduran Telecommunications Company (HONDUTEL), founded in 1977, is responsible for planning and executing projects and operating and maintaining all services in domestic and international telecommunications. Also, together with the National Supervisory Commission for Public Services (CNSSP), the company has regulatory and policy-setting responsibilities in the sector, making it a monopoly that is integrated both vertically and horizontally that is beset by typical problems and exhibits the same shortcomings as its counterparts elsewhere in the region.
- 2.15 The sector faces the following problems: (i) the regulatory and policy framework is imprecise and inadequate; (ii) service is deficient; (iii) there is substantial unmet demand; (iv) HONDUTEL lacks the technical and financial capacity to operate efficiently and the government does not have the resources to modernize and improve that capacity.
- 2.16 Service density is a mere 2.4 lines per 100 inhabitants, one of the region's lowest and not enough to compete in the global economy. Lines are congested, only 45 percent of calls get through; only about 16 percent of trouble is repaired within 24 hours. HONDUTEL has 36 employees per 1,000 lines, as compared to just four in well administered companies. A high proportion of the employees are engaged in administrative work.
- 2.17 In order to achieve the Latin American average for coverage, about 312,000 lines would have to be installed, at a cost of about US\$375 million, or close to 10 percent of GDP. That is clearly beyond the country's capacity for external indebtedness and would carry a high opportunity cost in terms of developing other economic and social areas.
- 2.18 To improve the sector's efficiency and enable it to contribute efficiently to the challenges posed by gaining a position for Honduras in the global economy, the program supports reform to improve the sector's institutional framework and attract technical and operational capacity and private risk capital for the delivery and expansion of services. In fulfillment of part of the

conditions for submission to the Board and release of the first tranche of the proposed operation, in October 1995 Congress passed the law to restructure the sector and amend HONDUTEL's charter. The law seeks to achieve a competitive system with appropriate rates and allow the private sector to take part in service delivery.

- 2.19 The reform provided for in the law includes the following policy elements: (i) adoption of a stable and transparent legal and regulatory framework; (ii) institutional reform to separate direct service delivery from the regulatory and policy-setting functions, the former to be carried out by HONDUTEL with private sector participation and the latter two by the State; 1/ (iii) creation of an autonomous and independent agency, the National Telecommunications Commission (CONATEL), charged with the regulation and oversight of services; (iv) establishment of a concession system as the main way of involving the private sector in service delivery; and (v) restructuring of the sector so that services are delivered under a system of open competitiveness, with the temporary exception of a period of exclusive rights to operate basic domestic and international telephone service.
- 2.20 The law stipulates that CONATEL is a deconcentrated entity operating with full technical, administrative and budgetary autonomy, with the following powers: (i) to enforce laws, regulations, technical standards and other domestic and international provisions on telecommunications; (ii) to take steps as needed to promote efficiency and competitiveness in the delivery of services (approve rates and minimum cost expansion plans); (iii) regulate rates for services which, as a result of market shortcomings, are provided under imperfect conditions of competitiveness; (iv) ensure equal access for operators and users; (v) grant, renew and revoke concessions, licenses and other permits for the delivery of services; and (vi) administer and monitor the use of the radioelectric spectrum.
- 2.21 The law also allows the private sector to invest in subsidiaries or commercial companies jointly with HONDUTEL. It stipulates that within two years after the entry into force of the law HONDUTEL is to take steps to allow one or more companies with a solid international standing in the telecommunications field, a sound financial position and proven technical expertise to enter into joint ventures with it, sign management contracts or agree on the creation of one or more commercial companies to operate domestic or international telecommunications services. It also specifies that these companies are to make equity investments in the company created in order to modernize and expand the telecommunications services entrusted to it.

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1/ The policy function belongs to SECOPT and the regulatory and oversight function to CONATEL.



- 2.22 The law includes the fundamental legal elements to allow concessions to be granted to a strategic operator for the delivery of basic domestic and international telephone services, as in bidding procedures held in Argentina, Mexico, Venezuela, Peru, and more recently Bolivia.
- 2.23 In order to attract private operators and strategic investors, the law grants HONDUTEL exclusive rights for up to 10 years for the delivery of basic and long-distance services. These exclusive rights will be transferred to the company or companies established by HONDUTEL under concession agreements with private operators. The conditions on which the services are to be provided will be stipulated by CONATEL.
- 2.24 Concessions will be granted under a public bidding process, generally without exclusive rights, and will be renewable. The effective participation by the private sector in delivering telecommunications services is reinforced by the conditions precedent to the second and third tranches as indicated in the policy matrix (see Annex I-1). A condition precedent to the second tranche was that the delivery of basic domestic and international telephone services be put out to tender, and a condition for the third tranche is that the private sector be allowed to participate in delivering the services.
- 2.25 Financing will be obtained for the sector through these concessions. The value of a concession is determined principally by the going concern value of the services involved. This value will be determined by the market, where strategic investors will compete in the bidding process. The anticipated net proceeds reflect mainly projections of growth in services plus rates approved under the rate schedule, and expenditures include, in addition to investments and operating costs, obligations deriving from liabilities transferred along with the concession, such as any financial and labor liabilities that may exist. This means that the operator will capitalize the company with investment and working capital, and any remainder could revert to the State. That amount, representing the net value of the transaction, would be used to select the bid from among those submitted by interested investors.
- 2.26 The strategy adopted, like other variants of privatization, poses risks and difficulties, which have been addressed in various measures. The three main issues are: the mechanism being approved for private sector participation, the exclusivity period, and the autonomy and independence of the regulatory body.
- 2.27 Mechanism for private sector participation: In view of the nature of the sector and the services contemplated, concessions for basic domestic and international telephone services call for operating rights to be agreed upon in the context of national sector policy, subject to regulation and with quality and coverage targets, and

accordingly with investment obligations associated with the delivery of the services. The contract also clarifies matters such as each party's share of the proceeds, taxes, the rate schedule, and the rights and obligations of investors and users. The concession agreement between the State and strategic investors is an integral part of the privatization process, quite independently of arrangements as to the final ownership of assets.

- 2.28 The exclusivity period: The aim of sector efficiency in the context of more rapid technological change makes it highly advisable and desirable to have the shortest possible period of exclusivity. Sector legislation authorizes a 10 year period, introducing the risk of encouraging inefficiency. However, the duration of the exclusivity period will have to be covered in negotiations leading up to the concession agreement. Market pressures in the face of rapid technological change detract from the credibility of such a long period, and it may be assumed therefore that a shorter period will be granted.
- 2.29 CONATEL autonomy and independence: The aims of a stable regulatory framework and an autonomous and independent CONATEL make it highly advisable and desirable that, in addition to staggered elections, the terms of office for directors be longer than those of the executive and legislative branches, and that CONATEL have its own revenues and be empowered to authorize its budget. Sector legislation stipulates four year terms for commissioners by constitutional mandate, and the rates paid by users to cover the cost of regulation go to the Treasury. These considerations introduce an element of risk into the operation that will be reflected in greater detail in concession contracts and could raise transaction costs in the sector. However, this problem should not be attributed to the specific strategy followed in this particular case, but is common to all privatization processes in countries just undertaking them and lacking long regulatory traditions.

b. Civil aviation

- 2.30 Civil aviation functions are split between various state authorities. Coordination among them is not sufficient to solve the problems of funding requirements, resource allocation and use, regulation and standards, and user problems.
- 2.31 Civil aviation in Honduras lags behind the level of development achieved by aviation globally and has not contributed to stimulating growth in the Honduran economy. The causes are a lack of autonomy in the current regulatory framework, overlapping responsibilities, inadequate allocation of resources, low historic levels of reinvestment, and a failure to apply efficient commercial practices. The lack of autonomy of civil aviation and decisions of a political nature have led to poor allocation of resources.

- 2.32 In 1993, the government initiated a plan to invest in airports, for the most part with concessional external financing, with which the Roatán and San Pedro Sula airports were built. The latter has not yet entered into operation because of the lack of supplementary infrastructure works. The commissioning of the investments planned, together with the new investment required to solve the existing problems, will call for a major financial effort to operate and maintain the airports with a degree of reliability compatible with international standards.
- 2.33 The government, through SECOPT and with technical cooperation provided under the World Bank's infrastructure rehabilitation program, has prepared a strategy to reform civil aviation. The strategy seeks to decentralize the Civil Aviation Directorate (DGAC), currently under SECOPT, by creating an autonomous public enterprise to operate some of the airports and air transport services, extending concessions for commercial services to the private sector, and creating an autonomous deconcentrated policy-setting and regulatory body. The government, with the support of technical cooperation funding provided in parallel to the proposed operation, will carry out the civil aviation concession plan and the investment plan. The human, material, and financial resources required to develop and maintain the equipment and infrastructure, and to establish the required safety standards, will be defined in this plan.
- 2.34 In short, the civil aviation subsector reform provided for in the public sector reform program aims to modernize the subsector to make it more competitive, more efficient, and less costly to the State. This will be done by modifying the legal framework to permit the creation of a commercial public company to operate concessions for airports and long-term services.
- 2.35 The submission to Congress of the bills for restructuring civil aviation and for creating the airport and air transport services corporation are conditions precedent to the program's first tranche. They were submitted to Congress in October 1995. By the end of 1996, the laws are expected to be in force and a concession granted for at least one international airport or major airport services. By 1997, a concession is to be granted for another airport or new concessions for major airport services.
- 2.36 Fiscal savings attributable to this reform will be US\$16.6 million, principally from the transfer of investment to the private sector, revenue from new services, and revenue increases due to the new rate structure and taxes generated by the company's activities and the private operators.

c. Ports

- 2.37 Port services are operated as a monopoly by the National Port Authority (ENP) in the country's six ports. More than 80 percent

of activity is centered on Puerto Cortés. Quality of service is poor and some of the services (e.g., stevedoring) are provided informally by hiring daily labor.

- 2.38 The ENP charges excessive rates for some services and lacks adequately maintained equipment, so that ports are underutilized. Despite the fact that the ENP has maintained a healthy financial situation in recent years, benefitting from its monopolistic situation, it is feared that this position will deteriorate in the coming years due to accumulated debt.
- 2.39 The ENP is oversized, with 1,100 employees at the end of 1993. In the public investment study prepared by the IDB and the World Bank in 1995, it is estimated that the number could be reduced to 600.
- 2.40 The government will prepare a reform strategy for the ports which, using the technical cooperation funding provided in parallel to this program, will help to decide the role of the ENP and of private sector participation. The reform seeks to improve the cost efficiency of services. Once the strategy has been defined, the government will initiate the process of opening the services to the private sector.

d. Electricity sector

- 2.41 The principal agency in the electricity subsector is the National Electrical Energy Company (ENEE), a vertically integrated state enterprise. Although in 1994 the process of private sector participation in energy generation was begun, most electricity production is in the hands of the ENEE, which provides service to 98 percent of the users.
- 2.42 Installed capacity in the interconnected electrical system rose to 620 MW generated by ENEE; 24 MW by ELCOSA, a private investor (to rise to 80 MW in 1995); and 40 MW by San Lorenzo, also a private investor. A private producer (RECO) serves the island of Roatán. The ENEE is responsible for most of the transmission and distribution, except 6 MW generated by ELCOSA which is sold directly to a group of small-scale clients.
- 2.43 The electricity subsector has been undergoing a severe crisis attributable mainly to the failure to add to capacity due to the drought of 1993 and 1994, in addition to heavy electricity losses of up to 28 percent of generated power. This crisis led to rationing of electricity for up to 12 hours per day in 1994, affecting all productive activity, and in particular agricultural, industrial and electricity production. Energy rationing was lifted at the beginning of 1995. In addition to the direct negative impact on the economy, rationing caused massive importation of generator sets and additional fuel which has also had an effect on the balance of payments. The crisis has left the ENEE in a deficit situation due to delays in approval of the rate increases required,

loss of income, cost overruns incurred from increased thermal generation, and the purchase of energy from private individuals and neighboring countries. The government has had to pay the company's debt service given the company's inability to service its own debt, and other obligations on the order of US\$35 million in the first half of 1995.

- 2.44 The reform of the electricity subsector was begun in 1991 with the support of the IDB and World Bank's energy sector loans, which are currently in execution. At the end of 1994, the Bank approved additional financing for the hybrid energy sector program, by means of loans 936-SF and 937-SF, for purposes of giving continuity to the sector's reform program, and in turn to support the government in solving the electricity subsector's crisis. A key instrument in the reform is the Electricity Subsector Framework Law which was passed by Congress in 1994. This law sets standards and regulates the subsector's activity, but during its passage several changes were introduced which affect, among other aspects, competition among generators of electricity; incentives for private investment in the subsector and the ENEE's autonomy continue to be limited by state intervention in its operations. The present operation therefore seeks to amend the law to correct the foregoing problems and enable private sector participation to become effective and efficient (see Annex I-1).
- 2.45 The new Electricity Subsector Framework Law created the Energy Bureau as the senior administrative body responsible for policy definition and formulation for the subsector. The law also created the national Electrical Energy Commission (CNEE) as the body responsible for supervision and implementation of the Framework Law. In 1991, the National Public Service Commission (CNSSP) was created as the subsector's regulatory body. There is currently no clear definition of functions and responsibilities between the various bodies responsible for regulation. The technical and economic criteria for setting rates established in the Framework Law have not been followed due to a lack of clarity in defining the roles of the bodies regulating the sector and the lack of independence of the current regulatory body. The regulatory body requires greater independence and technical strengthening to carry out its functions adequately. The current composition of the energy sector, with the creation of several commissions located in various ministries, responsible for various policy-setting, regulatory and business functions in the energy subsector, is not the most efficient and could give rise to overlaps and difficulties in coordination of its functions, so that it needs to be reviewed. The Bank, with MIF financing, is supporting a review of the subsector's legal framework and the formulation of the changes required to consolidate a clear framework of welcoming and promoting private investment. To monitor implementation of the reforms, the matrix for this operation includes the conditionality required to ensure the legal changes (see Annex I-1).

- 2.46 The ENEE's current debt is about US\$700 million, and the company's internal cash generation is insufficient to carry out the plans for expansion and adequate electrical service coverage. As a consequence, the expansion of the service has been minimal, and Honduras is one of the countries with the lowest access to electricity services. Active private sector participation in investment in the subsector is therefore required. It will first be necessary to clarify and strengthen the subsector's legal regulatory framework so that it provides greater incentives to private sector participation (see Annex I-1).
- 2.47 The electricity subsector law provides for a separation of electricity distribution from generation. The IDB, through technical cooperation funding under the hybrid energy loan (additional tranche), provides for the preparation of studies to define the regions and assets of the new distribution companies, and the tender documents for the sale. A contract is about to be awarded for the consulting services, and that several distribution companies are expected to be established. Giving continuity to the foregoing, in the third tranche of this operation, it is laid down that the delivery of the entire distribution service at the national level will be put out to final tender, and private sector participation will be provided for. This will be done in support of compliance with the law and to free the ENEE and the public sector of part of their financial burden.

## 2. Administrative reform

- 2.48 This component seeks to effect a major shift in the role played by the State in the economy by downsizing the public sector in terms of both its functions and its organization and personnel. The foregoing will make it possible to rationalize expenditure and improve efficiency. The administrative reform will be carried out through two subcomponents: institutional reform and rationalization of the employment and pay regime. It is based on action plans agreed upon by the government and the two Banks, which form an integral part of the policy letter and may be consulted in the files of Region 2.

### a. Institutional reform

- 2.49 This will involve: (i) restructuring four sectors with a high fiscal savings potential and eliminating serious structural problems (education, health and social services, natural resources, and infrastructure and communications); (ii) rationalizing the central ministries (Economic Affairs, Finance and Planning), which have an administrative structure that needs to be brought up to date to meet the needs of the current economy, and is segmented, with additional functions which are not coordinated and place constraints on promoting coherent investment planning and phasing; and (iii) providing support in the form of parallel technical

cooperation funding, to social security and other institutions in preparation for their reform.

- 2.50 Given the complexity of institutional reform, the government will prioritize activities expected in the sector for each tranche, and the Banks will verify satisfactory progress before approving disbursements under the successive tranches (see policy letter).

(i) Education

- 2.51 The strategy in this sector in support of the basic education project aims at concentrating the Ministry's activity on the basic primary and secondary level. The scarcity of public resources make it imperative that they be directed where they are most productive and cost effective. The intention is to transfer technical education to the private sector and to respond to market requirements. For this purpose, the Ministry of Education (SEP) will coordinate the development of a program which would be financed by the IDB with the Skills Training Institute (INFOP), the NGOs and the private sector. In this process, transfer of INFOP to the private sector is envisaged.
- 2.52 Plans also call for the SEP's internal reorganization, eliminating some departments and restructuring its functions, to replace the organization by levels with a functional structure. This will eliminate duplication of functions and allow human resources to be consolidated, particularly in training, curricula and supervision. The restructuring also seeks to decentralize the support services towards the departmental education directorates. The Ministry is setting up a system of teacher evaluation and a new procurement unit to adapt to the decentralization process. The construction division is eliminated and its responsibilities are transferred to the Honduran Social Investment Fund (FHIS) and the Ministry of Communications, Public Works and Transport (SECOPT).

(ii) Health

- 2.53 In this sector, the program's objective is to initiate policy reforms that improve institutional efficiency and rationalize public expenditure. It is anticipated that the reform process begun with the program will subsequently be supplemented with a specific operation for the sector, to be financed by the IDB.
- 2.54 The program calls for restructuring the Ministry of Health, seeking to: focus resources on basic services; adjust health policies and programs; redefine roles and "care models"; introduce transparent, efficient procurement procedures; and allocate financial and human resources more equitably in accordance with the population's epidemiological profile and socioeconomic conditions.

- 2.55 Plans also call for restructuring the Honduran Institute for Rehabilitation of the Handicapped (IHRM), making it a Ministry of Health regulatory program.

(iii) Communications and infrastructure

- 2.56 The strategy in this sector is to restructure SECOPT, giving it a policy-making and regulatory role and transferring operational activity to the private sector, such as development of infrastructure and maintenance. The central focus of this strategy is rationalization of the public investment program by decentralizing civil aviation and granting concessions for airports; intensifying maintenance subcontracting and road, port and airport construction and privatization of automobile repair shops, and production of traffic signals and modular bridges.

(iv) Natural resources

- 2.57 Reforms are to be made in the Ministry of Natural Resources (SRN) to allow it better to play its policy-making and regulatory role. The reforms will include: (i) replacing the crop and livestock directorates with a Science and Technology Directorate (DICTA), and setting up the National Agricultural Health Service (SENASA) and the Rural Development Directorate (DRI); (ii) transferring to the private sector responsibility for executing technology generation and transfer services; (iii) integrating into a new body the functions of the Agriculture Sector Planning Unit (UPSA) and the Sector Planning Unit (UPI); (iv) decentralizing the functions of the Regional Units Directorate to the regional offices, transforming the regional directorates into regional offices; (v) completing the process of eliminating intervention by the Honduran Agricultural Marketing Institute (IHMA) in the grain market and liquidating the enterprise; and (vi) privatizing legally and administratively the Honduran Coffee Institute (IHCAFE), creating the National Coffee Council as a policy-making body for coffee. The SRN's modernization process was begun with the execution of the agricultural sector program co-financed with the World Bank.

(v) Central ministries

- 2.58 Rationalization of the Ministries of Finance, Economic Affairs, and Planning is intended to make implementation of economic and financial policy more efficient. This is in line with the fact that in 1990 Honduras began a structural reform process that is leading it to abandon the state capitalism model in which the state played a leading role as the driving force of economic development, to adopt the modern, universal trend of orienting the economy towards the market.
- 2.59 On this premise, the Ministry of Finance (SHCP) will be dedicated exclusively to functions of a fiscal nature.



- 2.60 Within the SHCP, procurement functions will be decentralized to the administrative units of the public enterprises. The central procurement office was eliminated by Congress as an operating unit, and its functions are being decentralized to the administrative units of each public agency. The SHCP will maintain its policy-setting function for procurement.
- 2.61 The Ministry of Economic Affairs will be redirected toward furnishing support for activities transferred to the private sector. It will set standards and provide assurances so that the private sector can adequately fulfill its functions within an environment of competition. This Ministry would dispense with the functions of regulation and administration of economic controls and restrictions and controlling the use of subsidies to promote production. It will also drop its function of planning transport policy, conducting censuses, and preparing statistics.
- 2.62 The Ministry of Planning will be restructured and its functions related to social management and investment, which are the government's basic responsibility, as well as international technical cooperation, will be handled through a unit that will be created in the Office of the President.

b. Rationalizing public employment and pay

- 2.63 This component is designed to support the government in a significant, sustained reduction in public sector employment through the rationalization of institutions and restructuring of enterprises, providing for private sector participation. The program will support the government's employment rationalization plan through the restructuring programs being implemented in several priority sectors which have been supported by Law 135/94. In this law, cuts in positions are set for both the central and decentralized administration. The goal is a five percent net reduction in all positions in the sectors subject to reform by April 1995 and another five percent by April 1996 (based on strength in January 1994) (see Annex I-1).
- 2.64 The program will support the rationalization as it relates to: (i) reducing the number of redundant personnel and improving the professional/technician relationship; (ii) improving the civil service grade and pay structure; (iii) improving human resources management policy for teaching personnel; (iv) establishing control mechanisms for pay, employment levels and structure in the civil service and related systems, and for teachers, medical personnel and decentralized institutions and; (v) developing a strategy to integrate the various public sector employment systems.

3. Reform of public administration

- 2.65 The PME includes a broad public administration reform to ensure the sustainability of the fiscal savings resulting from administrative

reform. This will include: (i) integrated human resources management and effective control; (ii) integrated financial administration; (iii) investment planning; (iv) modernization of the purchasing and contracting system; and (v) institutional restructuring of the internal and external auditing control systems. Of these activities, the program will support the first three. The reform is based on action plans agreed upon by the government and the two Banks, which form an integral part of the policy letter and may be consulted in the files of Region 2.

- 2.66 In the area of integrated human resources management and control mechanisms, the program seeks to improve the information systems supporting management and control of human resources. The government has been implementing an automated payroll system for the civil service and other central government systems, which will be extended to the rest of the public sector. In addition, censuses and audits of health care positions are being carried out. This activity will be continued in other sectors, particularly in education. The government set up a technical group within the CPME to manage employment and pay policy, which will monitor employment indicators (see policy letter).
- 2.67 The reform will include the following activity: (i) systematic monitoring of employment in public sector systems in coordination with auditing activity; (ii) censuses and audits of selected posts in the ministries and decentralized institutions and establishment of systematic auditing mechanisms; and (iii) integrated human resources management and pay systems for the civil service and other public sector systems.
- 2.68 In the area of integrated financial administration, an attempt is made to: (i) eliminate the current duplication between bodies responsible for setting policy and coordinate the budget process; (ii) harmonize the basic financial administration functions, including budgeting, accounting, liquidity management, and the public debt; (iii) develop the accounting and liquidity functions more fully; (iv) reinforce budget planning and evaluation through development of mechanisms to assess performance and provide incentives to improve efficiency; and (v) design and implement an integrated financial administration system which makes it possible to execute expenditure in a decentralized fashion and have unified information to facilitate control (see policy letter).
- 2.69 In the area of investment planning, the objectives are to: (i) strengthen the authority responsible for planning, monitoring and evaluation of investments for which the public sector is responsible, ensuring consistency with the principal authority's functions in public finance; (ii) establish priority-setting mechanisms; (iii) establish standard evaluation and project selection criteria; (iv) develop and strengthen investment planning units within the government offices and bodies responsible for most public investment; and (v) establish mechanisms to integrate public

information in order to facilitate its planning and monitoring (see policy letter).

D. The lessons of past experience

- 2.70 The experience obtained from other sector reform processes being carried out in Honduras indicate that reforms should be kept simple but substantial enough to achieve genuine change and impact on the areas identified as crucial. In this respect, the program's technical team, with the support of consulting services under the PPF, conducted a highly detailed assessment of the activity currently being carried out by the government to determine the main bottlenecks (see Annex I-3). Also, the project team analyzed the fiscal and debt impact (see Annexes I-2 and II-1) to show clearly the significance of the reforms included. This work is reflected in the policy matrix (see Annex I-1).
- 2.71 In addition, account was taken of the recommendations of the study "Institutional Aspects of Public Enterprise Reform: the IDB Experience" conducted by the Bank's Evaluation Office in 1995 on the experience of four Latin American countries in the privatization process. In this connection, the recommendation that the reforms must be long-run was taken very seriously. The institutional model and the legal framework governing the privatizations were clearly defined. Various alternatives within this model were studied to analyze the suitability of the alternative selected, and it was determined that the basic legal requirements to execute the program should already be in place (in the case of energy reform) and insofar as possible submitted to and passed by Congress when they are imperative to timely execution (in the case of conditionality preceding to approaching the Board of Executive Directors for approval of the telecommunications sector reform and HONDUTEL restructuring laws). Under the technical cooperation, high level consultants were contracted who have supported the entire technical, institutional and legal process.
- 2.72 With regard to the recommendation of the study mentioned above on the importance of analyzing and strengthening the government's capacity for negotiating with the private sector and achieving a consensus on implementing the reforms, the program's design assigns much importance to sound government negotiations with the private sector, which will benefit it in the long run. In this regard, with the advance of PPF funds, a very detailed analysis has been carried out in the telecommunications sector, which will be continued with the technical cooperation funding provided in parallel to this program, to enable the government to choose the most politically viable alternatives of interest to the private sector. For aviation, the technical cooperation project will provide assistance in the process of determining the appropriate guidelines for negotiation.

- 2.73 On the recommendation that the institution responsible for the privatization process be supported, support is provided under the technical cooperation funding parallel to the program for the privatization commission responsible for this process for several of the sectors in which privatization will be carried out.
- 2.74 Experience in several countries has shown that the cost of services may rise when they are operated by the private sector, and thus affect consumers. To counteract this effect, the public services reform calls for policy-setting and regulation to remain the government's responsibility, through commissions to be formed both for telecommunications and aviation and the one already in existence in the energy sector.

### III. FINANCING AND EXECUTION

#### A. Program financing

- 3.1 The proposed operation will be financed jointly by the IDB and the IDA. The program's total cost will be US\$210 million, of which US\$155 million will be from the IDB and US\$55 million will be from the IDA. The IDB loan will be disbursed in three tranches, the first for US\$100 million, the second for US\$25 million, and the third for US\$30 million.
- 3.2 The amounts of the loan tranches were determined on the basis of the importance of the reforms included in each tranche and Honduras' immediate need to receive substantial support for import payments in order to free up resources to handle its urgent problems, including social problems and a large fiscal deficit. The program will be supported by parallel technical cooperation funding in the amount of US\$16.8 million, of which the IDB will provide US\$5 million, the IDA US\$9.7 million, and local counterpart funds will account for US\$2.1 million (see Annex III-1).

#### B. Conditionality and compliance for submission to the Board of Executive Directors

- 3.3 The conditionality proposed for the program is set out in Annex I-1. Disbursement of the tranches would be subject to: (i) maintaining an appropriate macroeconomic framework in accordance with the letter the government signed with the IMF in January 1995; and (ii) satisfactorily meeting the conditions of the entire program in accordance with the policy matrix and the policy letter.
- 3.4 The IMF mission that performed the interim evaluation in September found that good progress had been made in the adjustment program in terms of fiscal discipline. It is anticipated that the goal of reducing the fiscal deficit by 4.5 percent of GDP will be exceeded by the end of the year, as it is expected to reach 3 percent of GDP. On structural adjustment, the IMF mission found that the Financial Institutions Act had not yet been passed by Congress (it was passed on October 31), and that progress on the energy sector loan was still pending, especially concerning changes in rates. The mission agreed to negotiate the letter of intent and to submit it to the Board upon approval of the public sector reform program.
- 3.5 The conditions for the first tranche and the submission of the loans to the Board of Executive Directors relate to: (i) the passage by Congress and promulgation by the Executive of the Telecommunications Sector Reform Act and amendments to the HONDUTEL Charter. The law was passed by Congress on October 31, 1995, and Presidential signing is being processed; (ii) submission to

Congress of drafts of the Civil Aviation Restructuring Act, the creation of the Airports and Air Transport Services Company, submitted to Congress on October 31, 1995; (iii) issuing of the executive decree approving the institutional reform program (PRI), issued on August 18, 1995; (iv) have reflected in the draft general budget for 1996 the increase in funds allocated for basic education and primary care (in the process of being fulfilled); (v) have defined the new functional organizational structure for the economic affairs, finance and planning areas (in the process of being fulfilled); (vi) meet the employment reduction targets stipulated in Decree 135/94 (in the process of being fulfilled); (vii) substantial progress on first tranche activities outlined in the action plans for SEP, SSP, SECOPT, SRN, the economic and financial sector, the social services sector, pay and employment in the civil service and decentralized institutions, and financial management and investment programming (fulfilled).

- 3.6 The conditions for the second tranche would be: (i) Place in effect the Telecommunications Sector Reform Act and the amendments to the HONDUTEL Charter, put local and long-distance telephone services out to public tender, and commence operations by the regulatory agency, having made a budget allocation to this end; (ii) entry into force of the Civil Aviation Act and the National Airports and Air Services Company Act, and grant a concession for an international airport or important airport services; (iii) have placed in effect the necessary legal measures to improve the sector's institutional framework and grant incentives for private sector participation, and submit the study defining electricity distribution zones; (iv) have reflected in the draft general budget for 1996 the increase in resources allocated to basic education and primary care; (v) entry into effect of the functional organizational structure of the economic affairs, financial and planning areas; (vi) continue the program to rationalize employment, pursuant to Decree 135/94; and (vii) substantial progress on the second tranche activities in the action plans referred to in paragraph 3.5.
- 3.7 The conditions for the third tranche would be: (i) commence operations of the subsidiary charged with the delivery of basic and long-distance telephone services and control of operations by a private operator; (ii) grant a concession for a second airport or new important airport services; (iii) complete the ENEE public bidding process to award all energy distribution to the private sector; (iv) have reflected in the draft general budget for 1996 the increase in resources allocated to basic education and primary care (see Annex I-1); (v) maintain the net employment reduction achieved under Decree 135/94; and (vi) substantial progress on third tranche activities outlined in the action plans referred to in paragraph 3.5.

C. Execution

- 3.8 The program's borrower will be the Republic of Honduras. The program will be executed through: (i) the Presidential Commission on Modernization of the State (CPME), through the program coordinating unit (PCU) in the CPME Executive Secretariat; and (ii) the Ministry of Finance (SHCP), through the Consultative Commission on Privatization (CCP). SHCP will execute the public services reform component with the participation of HONDUTEL, SECOPT and ENEE. The activities of these institutions will be supervised by SHCP through the CPME Executive Secretariat in coordination with CPME. CPME will execute and coordinate the public administration reform component and the public administration reform component with the participation of the following institutions: (a) For the administrative reform component: (i) institutional restructuring subcomponent: SEP, SRN, SSP, SECOPT, SEC, SHCP, SECPLAN, JNBS and PANI; and (ii) public employment and pay reform subcomponent: SHCP and the Ministry of the Office of the President, through its Civil Service Directorate; and (b) For the public administration component: SHCP. These reforms will be carried out with support under the technical cooperation program and the activities and execution arrangements will be performed as set forth in the coordination and followup component.

D. Disbursements, procurement, and retroactive financing

- 3.9 The loan proceeds will be used to reimburse the foreign currency costs of the eligible imports. These imports must not be included on the negative list of imports.
- 3.10 The loan proceeds may be used to reimburse foreign currency outlays on eligible imports in the nine months prior to the signing of the contract, subject to an overall ceiling of 50 percent of the loan proceeds and provided that the borrower has complied with the procurement guidelines laid down in the operation. It is recommended that an exception be approved to the Bank's policy on the time period for this purpose (nine months rather than six), since the volume of resources under the tranches is greater than the volume of imports during the period. Consideration has been given to the fact that requests for recognition of expenses will be submitted to both the IDB and the World Bank, and that there are other disbursements pending under loans in execution such as the agriculture and energy sector loans.
- 3.11 It is recommended that the extension relating to the use of the bidding system for petroleum imports in amounts over US\$5 million be approved.

E. Auditing and control

- 3.12 The loan financing will be disbursed against expenditure statements which must be submitted to the Central Bank. These statements are to give details of transactions during the period and provide evidence that the eligibility criteria have been met. The information contained in the statements must include data on the type of importation, country of origin, dates, and value.
- 3.13 The CPME is responsible for maintaining the accounting records and preparing and submitting disbursement requests. The financial statements will be audited by a firm of independent auditors acceptable to the Bank. These statements are to be submitted within 90 days following the final disbursement under each tranche. The audited reports are to demonstrate, in accordance with the procedures accepted by the Bank, that the goods for which the disbursement request was submitted during the corresponding tranche are eligible for reimbursement using the financing proceeds.
- 3.14 The Banks reserve the right to make ex-post inspections of the various documents and stages of each acquisition related to the program.

F. Inspection and supervision

- 3.15 The Banks will lay down such inspection procedures as are deemed necessary to ensure the satisfactory development of the program and the executing agency is to furnish any cooperation required to accomplish this goal. Of the financing, US\$1.55 million will be paid into the IDB's general accounts for inspection and supervision.

G. Program monitoring

- 3.16 The program will be monitored with the support of a consultant-monitor for a full non-consecutive year, to be hired using the technical cooperation funds. The consultant will deal exclusively with matters relating to the program and the parallel technical cooperation funding. The Honduras Country Office will provide all the logistical support needed by the consultant in order to properly perform his duties. The consultant will not enter into an employment relationship with the Bank, and his labor rights will be only those included in the contract between himself and the CPME. The consultant will support the executing agencies in executing the program and technical cooperation. The consultant will receive ongoing support from the project team. To evaluate program execution and ensure an appropriate macroeconomic and legal environment, two visits per year will be made by the project team. The visits will be made at the beginning of each six-month period. The government must send a progress report on the reforms to the Banks before each such visit, in accordance with the action plans agreed and reflected in the conditionality matrix.



#### H. Technical cooperation

- 3.17 The reforms that the government is promoting require a series of studies and consulting services to implement the restructuring fully. The technical cooperation would support this activity in parallel to the program and would be cofinanced with the World Bank. Its specific objective is to assist the government to define and effect PME reforms, support implementation of those reforms included in the program, and strengthen the government's institutional capacity for execution of the program and fulfillment of the conditions. The technical cooperation funding will be used to support the following components:
- Reform of public services (opening up to the private sector and granting of concessions)
  - Institutional restructuring
  - Social security reform, including the Honduran Social Security Institute (IHSS) (financed by the World Bank and local counterpart)
  - Rationalization of the public employment and pay regime and human resources management
  - Financial administration and investment planning
  - Procurement systems
  - Environmental strengthening (financed by the IDB and local counterpart)
  - Project coordination and monitoring
- 3.18 The amount of the technical cooperation funding is US\$16.8 million, of which the IDB will lend US\$5 million, the IDA US\$9.7 million, and local counterpart funds will account for US\$2.1 million (see Annex III-1).

#### I. Impact on low income groups and the environment

- 3.19 In the case of the sector loans, especially those whose activity affects several sectors of the economy, there is no definite method of quantifying their impact on low income groups.
- 3.20 In terms of indirect effects on the social sectors, in the medium and long run the expenditure reforms will enhance competition by reducing the public sector monopoly over goods and services, and the funds required to provide them, while expanding the competitive scope of private sector participation. This will provide incentives to greater labor productivity by eliminating duplication and redundancy in the public sector and transferring employment to

more marketable private sector activities. Improved effectiveness could free funds to be directed towards vulnerable groups that have borne the brunt of economic adjustment. In addition, part of the reform is focused on the social sectors, which would improve efficiency in delivery of social services, improve the quality of human capital and alleviate poverty.

- 3.21 The Environment Committee, at its meeting of May 11, 1995, classified this as a Category II operation.
- 3.22 The IDB, the World Bank and the Canadian International Development Agency (CIDA) have supported the efforts of the area's governments to achieve sustainable development in Central American society through the Alliance for Sustainable Development, signed by the Presidents of the Central American countries and the Prime Minister of Belize. The guiding principles of the Alliance are in line with the principles deriving from the Bank's Eighth Replenishment. The Alliance demands simultaneous efforts and progress in a balanced fashion in the following areas: democracy, economic growth with equity, social development and sustainable natural resource management, and improvement of environmental quality.
- 3.23 Further, environmental legislation provides for the operation of the Consultative Environmental Council as a high-level advisory body to the Minister of the Environment and the Technical Advisory Committee as a permanent specialized scientific and technical advisory body to support the Ministry of the Environment (SEDA), the Consultative Council and the Ministry's technical directorates.
- 3.24 National environmental legislation also provides for the operation of environmental units in the following ministries and decentralized bodies: Natural Resources, Education, Justice and the Interior, Communications, Public Works and Transport, Honduran Tourism Institute, COHDEFOR, SANAA and ENEE. Projects such as the SEDA/World Bank environmental development project and the CIDA project with the Ministry of Education have supported environmental legislation.
- 3.25 Supplementing the government's efforts, through the technical cooperation funding the program proposes to: (i) technically and logistically strengthen the National Council on Sustainable Development (CONADES), to comply with the agreements signed by the government under the Central American Alliance for Sustainable Development; (ii) technically and logistically strengthen the environmental areas of the relevant ministries and the decentralized bodies subject to the reform: SECOPT, Education (in the curriculum reform strategy not covered by the CIDA program), Public Health and Natural Resources (see Annex III-1).

#### IV. BENEFITS, VIABILITY AND RISKS

##### A. Benefits

- 4.1 This program is key to restoring and maintaining macroeconomic stability and improving efficiency within the state apparatus. Rationalizing the government's major expenditure and revenue items will make the public sector smaller and more efficient, in turn enabling the private sector to provide the Honduran population with more efficient public services at lower cost. Private sector participation in the delivery of services and infrastructure will add a measure of competition and will allow the government to focus on its more essential regulatory and policy-setting functions.
- 4.2 Thus, the program will correct structural weaknesses which have caused difficulties in fiscal management, particularly on the expenditure side. Improvements in the budget process and policy formulation will allow the government to direct its resources towards programs reflecting political priorities, including the current ones focusing on social spending for vulnerable groups. The program is supported by a legal framework that is consistent with far-reaching, sustainable reform.

##### B. Risks

- 4.3 The proposed operation poses three potential risks. The first relates to the political commitment the reforms require. It is attenuated by the fact that the new administration has demonstrated its commitment by implementing even reforms carrying a high political cost, such as reducing employment and the fiscal deficit and reforms in the telecommunications sector, among others. The second risk relates to the scarcity of skilled personnel and technical resources to implement the reform. To offset this risk, a parallel technical cooperation project has been designed to support implementation of the program. The third risk relates to the complexity of executing and monitoring the program. The parallel technical cooperation project includes funding for a consultant-monitor to support execution, especially with respect to arrangements with the Banks and following up on the fulfillment of conditions (see section on execution in chapter III).
- 4.4 Significant progress has already been made on the program. Among other assurances of proper execution is the simplicity of the conditions, with only the most substantive being included. The conditions for the first tranche and approval by the Boards of the two Banks are conditions relating to legal aspects, in order to prevent these from becoming obstacles to execution of the program. These include: (i) passage by Congress of the Telecommunications Restructuring and HONDUTEL Reform Act; and (ii) submission to Congress of the Civil Aviation Reform Act and the Airport and Air Transport Services Company Act. Conditions for the remaining

tranches focus on priority reforms and on the possibility of progress being made within the time frames specified.

- 4.5 Execution arrangements for the program will be devised with support from the technical cooperation project (Annex III-1) whereby the proceeds of the Bank loans will be used to strengthen the capacity of the executing agencies, through specialists in each of the major program components (privatization, employment, institutional reform). Also, it is important that those arrangements provide for deconcentrating responsibility for the reforms in each of the institutions concerned and establishing a mechanism for coordination under the responsibility of the CPME.

*Office of the President  
Honduras*

October 27, 1995

Mr. Enrique V. Iglesias  
President  
Inter-American Development Bank  
Washington, D.C. 20577

Dear Mr. Iglesias:

The purpose of this letter is to outline the main sector policy and reform efforts made by the Government of Honduras, and to request your Bank to support a public sector reform program by providing US\$155 million to cofinance the program along with an IDA loan for US\$55 million. Technical cooperation funding for US\$17.4 million is being requested in support of program execution, and would be provided by the IDB, the World Bank, and the Government of Honduras through its local counterpart contribution.

1. The recent economic situation

Macroeconomic performance in 1995 has been promising thus far. Growth has resumed and the fiscal deficit has been reduced. Accordingly, GDP is expected to rise 3.5% in 1995, compared to the 1.5% drop in 1994. The steps taken in October 1994 to contain spending and augment tax revenues will make it possible to meet the fiscal targets agreed with the International Monetary Fund in January 1995. (For instance, the fiscal deficit has been trimmed to 4.5% of GDP, down from 7.5% in 1994 and 11.2% in 1993.)

Still, it is a widely known fact that high external indebtedness is one of the main obstacles standing in the way of improving economic and social conditions in our country. In 1994 the external debt stood at US\$4.172 billion equivalent, or 128 percent of GDP, and servicing it took 34 percent of our exports of goods and services. Debt to multilateral organizations accounts for 58 percent of the balance, the major creditors being the IDB, World Bank, and the Central American Bank for Economic Integration. The Government is now examining possible ways of addressing the debt management issue.

2. The program

The program is part of an extensive series of reforms being carried out by the Government to modernize the State and alleviate structural problems that generate recurring fiscal imbalance. These reforms are

being backed by the IDB and the World Bank under the energy and agriculture sector adjustment programs, for instance, and under other IDB initiatives such as the multisector credit program, technical cooperation for tax administration reform, and new programs now in preparation in addition to the one described herein. These include a comprehensive reform initiative with programs in water and sanitation reform, legal reform, and legislative reform. These reforms are also backed by the International Monetary Fund's Enhanced Structural Adjustment Facility.

As you are aware, despite the efforts made to date, the public sector continues to be oversized, with a highly complex and inefficient administrative structure. Agencies and activities must be updated, and monopolies in public services must be eliminated to make way for greater private-sector participation. The aim is to free the Government of the heavy investment and operating expenses which have engendered high debt levels.

Public sector spending is high. On the public payroll, which accounts for a sizeable proportion of such spending, are large numbers of unskilled positions involving redundant activities. High absenteeism and other features need to be addressed, and pay scales contain irrational elements that need to be corrected. Moreover, shortcomings in financial management hamper spending and investment programming, funding and control.

In view of the foregoing, the Government has launched a major initiative to modernize the State, setting up the Presidential Commission on Modernization of the State (CPME) to coordinate the effort. The Commission's Executive Secretariat designed the administrative reform and laid the groundwork for implementation. In August 1994 it formally presented the Council of Ministers with an extensive program for State modernization seeking to reduce the size of the state apparatus and make it more efficient. In October 1994, Decree 135-94 was passed by Congress, containing the Public Sector Revenue Restructuring and Expenditure Reduction Act. The act provides for significant measures that take a comprehensive approach to tackling the fiscal crisis and furthering modernization. Examples are measures lending impetus to the reform of public services, bringing private sector involvement and focusing State action on regulatory and policy-setting functions; the modernization of institutions and procedures by merging and eliminating financial agencies and obsolete processes, and downsizing through staff cuts. Several of these steps have been prepared using technical cooperation funding from the IDB and the World Bank, and some are already under way. The public payroll was trimmed by 2,517 positions between January 1994 and June 1995. The Telecommunications Sector Restructuring and HONDUTEL Reform Act was placed before Congress in April 1995 and passed the first reading on October 26, 1995. The following draft legislation has been prepared and will be submitted to Congress in the near future: the Civil Aviation Reform Act, the National Airports and Air Service Corporation Act, and the new Public Administration Act. Executive Decree 030/95 has been issued approving institutional reform

programs for the agencies subject to reform, and concession legislation is now being drafted. Several of these actions have been included as program conditions, as shown in the attached policy matrix.

I would like to point to some of our accomplishments in connection with fulfillment of conditions precedent to submission of the public sector reform program to the Board and to disbursement of the second tranche of the agriculture sector loan, the additional tranche of the energy sector loan, and approval of the Financial Institutions Act. The conditions precedent to disbursement for the agriculture sector loan were fulfilled in June 1995, and the Financial Institutions Act was passed by Congress on October 26.

Substantial progress has been made on some of the conditions precedent to the energy sector loan (additional tranche), and a significant effort is being made toward full compliance before the operation is submitted to the Board. The progress can be summarized as follows: creation of the National Electric Power Commission, hiring of an individual consultant to determine consumption levels eligible for subsidies, hiring of a consulting firm to perform studies for privatizing electricity distribution, submission of a preliminary version of the new electric power tariff schedule, submission of the maximum fuel price schedule for calculating periodical adjustments for the consumer, and submission of the draft Hydrocarbons Marketing Act.

In order to continue implementing the reform program, I would like to appeal to the Bank, on behalf of the Government of Honduras, to provide financial and technical support for implementation of an integrated program to include those reforms that will have the greatest impact on fiscal matters and external debt and lead to a more efficient public administration. They are as follows:

A. Reform of public services. The objective is to promote greater efficiency in the delivery of public services in those sectors and subsectors generating high fiscal costs and external debt service, such as telecommunications, the electric power subsector, and civil aviation.

1. Telecommunications reform: To solve the core problems facing the sector and enable it to contribute efficiently to meeting the challenge of positioning Honduras in the global economy, we have designed and begun to implement a reform program to expand, diversify and update the country's telecommunications services. We intend to achieve these objectives through sector reform to attract technical and operating capacity as well as private risk capital for the delivery and expansion of services in the sector.

The program includes the following policy elements:  
(1) adoption of a stable and transparent legal and regulatory framework; (2) institutional reform to separate the regulatory

and policy-setting functions from operation of the service so that the first two pertain to the State and the latter to the private sector; (3) creation of an autonomous and independent body, the National Telecommunications Commission (CONATEL), to regulate and oversee the services; (4) use of the concession system as the main means of involving the private sector in service delivery; and (5) with the temporary exception of a period of exclusivity for the operation of basic domestic and international telephone services, restructuring of the sector so that services are provided in a context of unimpeded competition.

2. Civil aviation reforms: The objective is to update the subsector and make it more competitive, more efficient, and less costly to the State. This would be achieved by adjusting the legal framework to provide for the creation of a public commercial company and the granting of concessions for airports and long-term services.
3. Electric power subsector reforms: The aim is to continue to improve the sector by modifying the legal framework to allow private sector involvement in power distribution and assist in restructuring the ENEE. This would release the Government from a portion of future investment expenditure and associated debt implications. The program would initiate the transfer of distribution to the private sector as well. Included as an important part of the program to this end is the condition that a call for bids be issued to transfer provision of the entire power distribution service to the private sector nationally, awarding the contract to the winning bidders under the program.

B. Administrative reform. This component seeks to bring about a fundamental shift in the role played by the State in the economy by downsizing the public sector in terms of both its functions and its organization and staff. The downsizing encompasses two subcomponents: institutional reform, and employment and pay reform.

1. Institutional reforms: These would be carried out in: (1) four priority sectors with a high potential for generating fiscal savings and eliminating serious structural problems in education, health and social services, infrastructure and communications, and natural resources. Major policy reforms and administrative reforms would take place in the four sector ministries (SEP, SSP, SECOPT and SRN) and in some of the decentralized agencies (JNBS and PANI); (2) the areas of finance, economic affairs and planning, to address an administrative structure that is not responsive to the needs of the economy, is compartmentalized and includes additional functions that hamper coherent planning and programming; and through (3) the provision of support, under technical cooperation funding in parallel to the program covering social



security and other institutions, for the preparation of reforms. This component would be carried out in accordance with the conditions set out in the policy matrix and agreed upon with the Bank and the attached action plans for the institutional restructuring of the Ministries of Education, Health, Public Works and Transport, Natural Resources, Economic Affairs, Finance and Planning, and of the social services sector, which are deemed to be an integral part hereof.

2. Public employment and pay reform: The aim of this subcomponent is to enable the Government to carry out a broad and sustained rationalization of public sector employment, by privatizing companies and downsizing institutions. The reductions are to be consistent with those contained in article 27 of Law 135/94. The program would back rationalization to: (1) reduce the number of redundant staff and improve the ratio of professional to technical staff; (2) improve grade structures and pay scales in the civil service; (3) improve human resources management policy in the teaching profession; (4) establish mechanisms for control of payments and employment levels and structures in the civil service and related regimes for teachers, medical personnel, and the staff of decentralized agencies; and (5) develop a strategy to integrate information systems for the various public sector employment regimes. This component would be carried out in accordance with the conditions set out in the policy matrix and agreed upon with the Bank and the attached action plans for pay and employment reform in the civil service, related regimes and decentralized institutions.

- C. Public administration reform. This would include: (1) integrated human resources management and effective control by improving information systems in support of human resources management and control. The Government has been implementing a payroll information system in the civil service and other central government regimes, to be extended to the rest of the public sector. Censuses and audits will be performed as well; (2) integrated financial management to eliminate current overlapping functions of agencies in setting standards and coordinating the budget process, harmonize basic financial management functions, further develop accounting and financial functions, and design and implement a financial management system; and (3) investment programming to put in place mechanisms to set priorities and guide the programming of public spending, set standard evaluation criteria for those activities to continue to be performed by the State, and reinforce the agency in charge of investment programming, monitoring and evaluation, and the units in charge of public investment. This component would be carried out in accordance with the conditions set out in the policy matrix and agreed upon with the Bank and the attached action plan for modernization of financial management and investment programming.

We would like to convey our appreciation for your consideration of this most vital program, along with the assurances of our highest esteem.

[signed]  
Guillermo Bueso  
Coordinator, Economic Cabinet

[signed]  
Armando Aguilar Cruz  
Minister, Office of the President  
Presidential Commission on  
Modernization of the State

[signed]  
Juan F. Ferrera  
Minister of Finance

Annexes: As indicated

HONDURAS: STRUCTURAL ADJUSTMENT LOAN FOR PUBLIC SECTOR REFORM  
POLICY MATRIX

OBJECTIVES	MEASURES ADOPTED	CONDITIONS PRECEDENT TO:		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
<b>I. ECONOMIC FRAMEWORK:</b>	Letter of intent for the 1995-96 program signed with IMF. ESAF approved by IMF Board. Targets for first ESAF review met (approved in January 1995).	Macroeconomic management consistent with the sector program.	Macroeconomic management consistent with the sector program.	Macroeconomic management consistent with the sector program.
<b>II. REFORM OF PUBLIC SERVICES:</b>				
Redefine the role of the State by focusing its activity on setting policy and standards and regulation, and open up the provision of public goods and services to the private sector. Improve the efficiency, coverage and competitiveness of public services.				
<b>A. Telecommunications</b>  1. Assign the private sector a greater role in delivering telecommunications services to increase, streamline and modernize supply. 2. Bring greater efficiency to the State's regulatory and policy-setting role.	Telecommunications Sector Framework Act amending HONDUTEL charter passed by Congress, regulatory body (CONATEL) created, and private sector allowed to operate and invest in the sector.	Passage by Congress and promulgation of Telecommunications Sector Framework Act amending HONDUTEL charter and creating CONATEL.	Place in effect Telecommunications Sector Framework Act amending HONDUTEL charter and regulations and creating CONATEL.  Distribute final documents calling for public bids to select HONDUTEL operator, to invest and operate through one or more subsidiaries or with one or more commercial companies, responsible for granting concessions for basic domestic and international telephone services with national coverage.  Allocate CONATEL budget and initiate its operations.	Commence operations of subsidiary(ies) or commercial company(ies) responsible for providing basic and long-distance domestic and international telephone service, with national coverage, subject to operational audit by a private operator.

OBJECTIVES	MEASURES ADOPTED	CONDITIONS PRECEDENT TO:		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
B. Civil aviation	Following legislation drafted to Banks' satisfaction: Civil Aviation Act and National Airports and Air Services Corporation Act.	Place before Congress draft Civil Aviation Act and National Airports and Air Services Corporation Act.	Place in effect Civil Aviation Act and National Airports and Air Services Corporation Act.  Grant a concession for an international airport or major airport services.	Grant a concession for an airport in addition to the one in the second tranche and/or new concessions for major airport services.
C. Electric power	<p>Passage of Electricity Subsector Framework Act, authorizing the sale of distribution systems.</p> <p>Progress on private sector involvement in power generation. Contracting of a study to define geographical power distribution regions.</p>		<p>Based on the recommendations of technical studies reviewing the regulatory and policy-setting framework in the electricity subsector, place in effect needed legal measures to improve sector institutional framework and grant incentives for private sector involvement.</p> <p>Present study defining geographical areas where power distribution will be privatized.</p>	Complete bidding process by ENEE to transfer <u>entire</u> power distribution service to the private sector at the national level.

OBJECTIVES	MEASURES ADOPTED	CONDITIONS PRECEDENT TO:		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
<b>III. PUBLIC SERVICE REFORM</b>				
<b>A. Institutional restructuring</b>				
Downsize and improve organization and management by: (a) eliminating redundant and obsolete agencies and functions; (b) modifying and rationalizing agencies by means of recentralization, deconcentration, transfers to the private sector, outsourcing, and decentralization. Executive Decree of August 18, 1995, issued approving institutional reform plans for priority bodies, including the Ministries of Education, Health, Public Works and Transport, and Natural Resources, the social services sector and the economic affairs and financial area.				
<u>Education</u> Focus the greater part of resources on basic education		In the draft SEP budget for 1996, reflect an increase in the share taken by basic education from the current 50% to 52%.	Reflect an increase in the share of SEP resources taken by basic education, to 54% in budget performance for the fiscal year following the first disbursement.	Reflect an increase in the share of SEP resources taken by basic education, to 56% in budget performance for the fiscal year following the second disbursement.
<u>Health</u> Focus the greater part of resources on primary care.		In the draft SSP budget for 1996, reflect an increase in the share taken by primary health care from the current 44% to 46%.	Reflect an increase in the share of SSP resources taken by primary health care, to 48% in budget performance for the fiscal year following the first disbursement.	Reflect an increase in the share of SSP resources taken by primary health care, to 50% in budget performance for the fiscal year following the second disbursement.
<u>Economic Affairs, Finance, and SECPLAN</u>		Define organizational structure for economic affairs, finance and planning areas.	Place in effect the new functional organizational structure for the economic affairs, finance and planning areas.	

OBJECTIVES	MEASURES ADOPTED	CONDITIONS PRECEDENT TO:		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
B. Public employment and pay reform				
Cutbacks in unnecessary jobs in the civil service, related regimes in the central government (except for teaching and medical staff), and decentralized agencies				
	<p>Decree 135-94 established a program to rationalize public employment, excluding medical and teaching staff, with a target of a 10% reduction in permanent positions in the central and decentralized government by April 1996.</p> <p>As of June 1995, a 4.19% cut had been achieved in the central government and a 2.55% cut in decentralized agencies over June 1995.</p>	<p>Achieve reduction targets set forth in article 27 of Act 135/94 for the central government and decentralized agencies.</p>	<p>Achieve employment reduction targets set forth in article 27 of Decree 135/94 for the central government and decentralized agencies.</p>	<p>Maintain net employment reduction achieved pursuant to Decree 135/94.</p>

**IMPACT OF THE PROGRAM ON EXTERNAL DEBT AND DEBT SERVICE  
(ASSETS AND LIABILITIES)**

**A. Background**

The external public debt is one of the major problems facing Honduras, partly because of the size of the debt, but also because debt service imposes severe constraints on the availability of foreign exchange. In 1994, the debt amounted to US\$4.172 billion (128 percent of GDP), and debt service was equivalent to 34 percent of exports and 12 percent of GDP. Fifty-two percent of the debt is multilateral debt, and the IDB, the World Bank, and the Central American Bank for Economic Integration (CABEI) are the major creditors, accounting for US\$850 million, US\$726 million, and US\$365 million, respectively. Although the debt owed to the IDB is the largest, the country's debt in non-concessional funds is greater with the World Bank and CABEI.

Service on the total debt was US\$391 million in 1994, with multilateral debt accounting for US\$261 million, broken down as follows: US\$89 million to the World Bank, US\$81 million to CABEI, and US\$61 million to the IDB, with the rest accounted for by other creditors.

**B. Impact of the reform program on external public debt**

Given the IDB's strategy for Honduras, the public sector reform program (PRSP) is critical as it will reduce the amount of debt and debt service, while also changing the structure of the debt.

(i) With respect to the amount owed, the following consequences can be expected: (a) direct impact deriving from the elimination of all or part of the debt of the Honduran Telecommunications Company (HONDUTEL). 1/ As the Government would allow private sector involvement by creating subsidiaries with HONDUTEL and private capital, the authorities can realistically be expected, in their negotiations with the private sector to "establish the going concern value of the concession services", to devise appropriate mechanisms to transfer part or all of the debt to the subsidiary. It has been assumed in this analysis that at least 50 percent of HONDUTEL's debt would be transferred; (b) potential impact that would depend on the concession price. If we postulate a conservative scenario in which the the inflow of capital on concessions to subsidiaries is US\$440 million, then the additional impact would amount to US\$85 million, if the Government of Honduras earmarks the net proceeds to the repayment of debt.

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1/ The debt amounts to US\$270 million, and the main creditors are as follows: Chase Manhattan Bank (US\$76 million), Citicorp (US\$76 million), Japanese Overseas Economic Cooperation Fund (US\$58 million), CABEI (US\$36 million).

Under this scenario, Honduras could achieve a significant reduction in its debt, potentially on the order of 5.3 percent (US\$220/4,172 million), if, in addition to the elimination of 50 percent of HONDUTEL's debt, the total amount of revenue from private sector participation is earmarked for the same purpose. If it is earmarked for other purposes, then the operation would result in debt reduction of the order of 3.2 percent. In GDP terms, the debt reduction could amount to the equivalent of 6.6 percent.

These calculations are based on the amount of debt owed as at December 31, 1994. However, any increases in the total debt could alter the estimates. In particular, under the public sector reform program, the debt increases by US\$124 million (including US\$14 million in technical cooperation funds), so that the maximum reduction in the total debt would be 5.1 percent (US\$220/4,296 million) and the minimum reduction would be 3.1 percent (US\$135/4,296 million). Although under this scenario the debt/GDP ratio would tend to increase, the final outcome would depend on the rate of growth in GDP. The principal benefit of this operation is that Honduras will receive concessional debt financing and will reduce its non-concessional debt, which in turn will enable debt service to be reduced over the next 10 years by US\$15 million per year on average, as indicated in item (ii).

(ii) With respect to external debt service, the public sector reform program could generate additional debt relief of the order of US\$27.5 million, corresponding to US\$15 million in debt prepayments which Honduras would make on its IDB ordinary capital loans (cf. tables 2 and 5) and the reduced debt service which the 50 percent debt elimination would entail for HONDUTEL, amounting to US\$12.5 million (US\$9.5 million in capital repayment). 2/ The US\$15 million in debt relief would mean a 24.6 percent reduction (US\$15/US\$61 million) in debt service to the IDB in 1994. The US\$27.5 million in debt relief would correspond to a seven percent reduction in total debt service (US\$27.5/US\$391 million). The share of export earnings earmarked for debt service (and which would thus be freed up) would accordingly fall from 34 percent in 1994 to 30 percent.

(iii) With respect to the change in the debt structure (debt profile), this change will come about once non-concessional debt is reduced using concessional resources: (a) there will be a direct impact on the debt owed to the IDB as a result of the prepayment of US\$100 million (although the debt increases by US\$62 million under the public sector reform program), with a drop from 38 percent (US\$329/850 million) of ordinary capital debt to the IDB to 25 percent (US\$229/850+55+7 million); and, (b) as a result of the privatization of telecommunications, the debt will be reduced by US\$135 million, which will further reduce the share of Honduras's debt accounted for by trade debt. In addition, to the extent

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2/ See: Report by the public investment evaluation mission, telecommunications sector, World Bank 1994.



that the net proceeds from concessions for telecommunications services (US\$85 million) are earmarked for repayment of non-concessional debt, the debt profile will be modified even further. As the debt profile undergoes a shift from non-concessional to concessional funds; Honduras will obtain longer grace periods, lower interest rates, and longer maturities for payment of debt service. By helping to reduce out flows, this will allow funds to be put to more desirable alternative uses.

(iv) These calculations are based on revenue from private participation in telecommunications of US\$440 million, which is a conservative estimate; the beneficial effects of private sector involvement on debt and debt service reduction could be even more substantial. Likely scenarios, in which such revenue could go as high as US\$600 million or US\$800 million, are shown in Table 1.

Table 1

SCENARIOS: EXTERNAL DEBT IMPACT OF  
THE PUBLIC SECTOR REFORM PROGRAM

	Selling price US\$440 million		Selling price US\$600 million (2)		Selling price US\$800 million (2)	
	US\$ M	%	US\$ M	%	US\$ M	%
<b>Impact on debt amount (1)</b>						
I. Reduction of total debt	220	5.3	300	7.2	400	9.6
II. Reduction of debt/GDP ratio		10.8		9.0		12.1
<b>Impact on debt service</b>						
I. Reduction of service/total service	27.5	7.0	27.5 (3)	7.0 (3)	27.5 (3)	7.0 (3)
II. Reduction IDB service/IDB service	15	24.6	15	24.6	15	24.6
III. Reduction IDB service/total service	15	3.8	15	3.8	15	3.8
<b>Change in IDB debt structure</b>						
I. Reduction of ordinary capital debt	100	30.3	100 (4)	30.3 (4)	100 (4)	30.3 (4)
II. Structure of ordinary capital debt	229	25	229	25	229	25

- (1) This table shows the maximum benefits resulting from each alternative scenario.
- (2) This scenario postulates that the revenue from concessions is used to reduce the amount of the external debt.
- (3) The calculations underestimate the impact of these scenarios because whenever the amount of debt owed is reduced, the amount of debt service is reduced simultaneously. The lack of information on the financial costs of the various types of debt makes it difficult to estimate precisely the reduction in debt service; accordingly, the same impact is postulated as in the case of the most conservative scenario.
- (4) This calculation is also an underestimate, and is based on the results of the first scenario. Final impact will be determined by the amount set aside for settling debts owed to the IDB.

C. Other possible effects

The privatization of other state companies could have further effects on the reduction of external public debt if the proceeds of either the sale of fixed assets or service concessions are used to reduce the overall amount of the external debt. Although the impact would not be as immediate as in the case of telecommunications, the privatization of energy, civil aviation and port services would have major implications.

The national electric power company (ENEE), for instance, has five hydroelectric power plants and six thermoelectric power plants. The largest is El Cajón, which has installed capacity of 300 MW but generates just 180 MW. The selling price for power would have to be US\$0.115 per kW/h to cover the company's marginal costs, but it is actually US\$0.085/kW/h, leading the company to incur an estimated US\$30 million in losses in 1995. Moreover, 30 percent of the company's installed capacity is unusable given the poor condition of electrical wires throughout the country.

In its financial statements as at December 31, 1994, the company posted fixed assets of approximately US\$1,150 million, and liabilities of US\$700 million (mainly external), which accounted for 18 percent of the public sector's external debt. Major creditors are the World Bank (including IDA), at US\$259 million; the IDB, at US\$224 million; and CABEI, at US\$45 million, although under the PRSP the company's debt to the IDB would be reduced by US\$100 million (through prepayment of the debt on the El Cajón dam). It would be unrealistic, given the size of the debt, to contemplate privatization of the company's assets, but marketing and distribution (metering, billing, collection, customer service) could be privatized. Although the Electricity Subsector Framework Act passed in 1994 allows the private sector to take part in generating power, the law needs to be amended before such participation can actually materialize.

In the context of the energy sector program in execution, one of the objectives of the technical cooperation project is to have a consulting firm conduct a study to evaluate the company's assets overall and to support the ENEE in defining the geographical areas in which distribution regions are to be divided. Based on the clearer picture of the company's assets and liabilities in each region that will be available upon completion of the study, the benefits that privatization of marketing and regional distribution would bring for the company and for the country overall would be calculated.

With respect to airport services, which fall under the Ministry of Public Works and Transport, the PRSP calls for adoption of a new Civil Aviation Act, as well as an act creating an autonomous agency (the Honduran Airport and Air Transport Services Company) with the authority to grant concessions to the private sector for some of its operations. The minimum yearly investment required to enable civil aviation to operate efficiently and offer the necessary assurances has been determined to be US\$14.2 million. The new legislation would allow the private sector to

make this investment by executing the necessary physical works in exchange for long-term concessions for the operations concerned. The proceeds on concessions for the management of airport services, in an amount now being determined with technical assistance from UNDP, could be used to pay down the external debt.

In the ports subsector, the PRSP calls for preparation of an action plan to restructure the sector and make way for private sector participation via concessions for services. The recommendations of the study on privatization commissioned by the National Port Authority, to be conducted this year, will serve as a basis for preliminary estimates of the advantages of using concessions, and will be supplemented by external advisory assistance. It would be premature at the present time to make such estimates or to determine the potential impact on reduction of the company's external debt (US\$35 million as of December 1994).

Table 2  
HONDURAS: External Debt in 1994

	US\$ M (*)	Percentages
<b>* Public debt</b>	<b>3,591.0</b>	<b>86.0</b>
- Multilateral	2,178.0	52.2
IDB	850.0	20.3
Concessional	520.6	12.5
Ordinary capital	329.4	7.8
World Bank	726.0	17.4
Concessional (IDA)	291.0	6.9
Ordinary capital	435.0	10.5
CABEI	365.0	8.7
IMF	106.0	2.5
Others (IFAD, BLADEX)	131.0	3.1
- Bilateral	1,413.0	33.8
Paris Club	1,058.0	25.4
Other	355.0	8.4
<b>* Private debt</b>	<b>357.0</b>	<b>8.6</b>
Commercial banks	139.0	3.3
Other	218.0	5.3
<b>* Short-term debt</b>	<b>224</b>	<b>5.4</b>
<b>TOTAL</b>	<b>4,172.0</b>	<b>100.0</b>

Sources: World Bank, IDB, IMF, Central Bank of Honduras  
(\*) Provisional data

**Table 3**  
**HONDURAS: External Debt Service in 1994**

	Millions of US\$ (*)	Percentages	Total Serv./Exp. Percentages
<b>Total debt service</b>	<b>391.0</b>	<b>100.0</b>	<b>33.7</b>
Principal	250.0	64.0	21.6
Interest	141.0	36.0	12.1
<b>Multilateral</b>	<b>261.0</b>	<b>66.7</b>	<b>22.5</b>
<b>IDB</b>	<b>61.1</b>	<b>15.6</b>	<b>5.3</b>
Principal	31.1	8.0	2.7
Interest	30.0	7.6	2.6
<b>World Bank</b>	<b>89.0</b>	<b>22.7</b>	<b>7.7</b>
Principal	50.0	12.8	4.3
Interest	39.0	9.9	3.4
<b>IMF</b>	<b>21.0</b>	<b>5.4</b>	<b>1.8</b>
Principal	16.0	4.0	1.4
Interest	5.0	1.4	0.4
<b>CABEI</b>	<b>81.1</b>	<b>20.7</b>	<b>7.0</b>
Principal	51.5	13.1	4.4
Interest	29.6	7.6	2.6
<b>Other multilateral debt</b>	<b>8.8</b>	<b>2.3</b>	<b>0.7</b>
<b>Bilateral (including Paris Club)</b>	<b>66.0</b>	<b>16.8</b>	<b>5.7</b>
Principal	48.0	12.3	4.1
Interest	18.0	4.5	1.6
<b>Other</b>	<b>64.0</b>	<b>16.5</b>	<b>5.5</b>
Sources: World Bank, IDB, IMF (*) Provisional data.			

Note: Total exports in 1994 - US\$1,158.3.  
Source: Central Bank of Honduras/IMF

**Table 4**  
**HONDURAS**  
**IDB: Loan approvals, disbursements, and repayments, 1986-1994**  
**(US\$ millions)**

<b>Year</b>	<b>Approvals</b>	<b>Disbursements</b>	<b>Service</b>	<b>Net</b>	<b>Total Debt</b>
1986	122.4	31.4	23.8	7.6	479.5
1987	0.0	9.2	19.9	-11.4	517.9
1988	50.9	61.8	52.5	9.3	553.7
1989	0.0	35.1	25.0	10.1	571.6
1990	104.0	73.2	74.8	-1.6	344.3
1991	215.0	27.5	56.8	-29.3	627.7
1992	133.5	109.1	57.7	51.1	692.8
1993	24.2	118.8	58.1	59.0	798.6
1994	54.0	76.7	61.1	14.2	849.1
<b>Average 1990-1994</b>	<b>106.1</b>	<b>81.1</b>	<b>61.7</b>	<b>19.3</b>	

Source: IDB

**Table 5**  
**HONDURAS**  
**COMPARISON OF CASH FLOWS ON ORDINARY CAPITAL LOANS AND CONCESSIONAL LOANS**

Loan	Balance outstanding as at December 31, 1994	Net present value	End-of-period cash flow	Annual amortization and interest (average 1995-2000)	Annual amortization (average 1995-2000)	Number installments
130/IC-HO (*) 117/IC-HO (*)	97,946	108,969 <sup>1/</sup>	147,813	16,206	9,500	2
NNN/SF-HO (**)	97,946	36,993	137,614	980		6

Note: (\*) Discounted to 6.7 percent interest. (\*\*) Discounted to 6.7 percent, 10 years' grace period, 1 percent during the first 10 years, and 2 percent for the remaining period.

<sup>1/</sup> Does not include estimated fluctuations in the basket of currencies.

HONDURAS: ROADMAP OF MAIN STRUCTURAL REFORMS

	Issue	Program	Instruments	Current Status	Reforms pending termination of
y	Imprecise legal and regulatory framework	<ul style="list-style-type: none"> <li>•Energy Sector Loan</li> <li>•Public Sector Reform Program (PSRP)</li> </ul>	<ul style="list-style-type: none"> <li>•<i>Framework Law of the Energy sector</i></li> <li>•Creation of Regulatory Commissions and Energy Cabinet</li> <li>•New law to adjust Framework Law</li> </ul>	<ul style="list-style-type: none"> <li>•Complied in second and third tranches of energy sector loan</li> <li>•Included in PSRP</li> </ul>	None
	Operational inefficiencies of ENEE	<ul style="list-style-type: none"> <li>•Energy Sector Loan</li> <li>•Public Sector Reform Program (PSRP)</li> </ul>	<ul style="list-style-type: none"> <li>•Action Plan to regionalize and incorporate distribution companies</li> <li>•Bidding and selection of private sector participation in distribution</li> </ul>	<ul style="list-style-type: none"> <li>•Action Plan is part of TC in Energy Sector Loan</li> <li>•Bidding and selection is third tranche condition of PSRP</li> </ul>	None
	Inadequacy of oil supply system	<ul style="list-style-type: none"> <li>•Energy Sector Loan</li> </ul>	<ul style="list-style-type: none"> <li>•Oil liberalization program</li> <li>•Action plan for market liberalization</li> </ul>	<ul style="list-style-type: none"> <li>•Energy Sector Loan fourth tranche condition</li> </ul>	None
	Inappropriate institutional tariff arrangement	<ul style="list-style-type: none"> <li>•Energy Sector Loan</li> </ul>	<ul style="list-style-type: none"> <li>•New Framework Law includes new institutional arrangements</li> </ul>	<ul style="list-style-type: none"> <li>•Included in fourth tranche of energy loan</li> </ul>	None
	Heavy fiscal load due to weak financial situation of ENEE	<ul style="list-style-type: none"> <li>•Energy Sector Loan</li> </ul>	<ul style="list-style-type: none"> <li>•Framework Law allows privatization of distribution</li> <li>•Bidding and selection of private sector participation in distribution</li> </ul>	<ul style="list-style-type: none"> <li>•Framework Law approved</li> <li>•Bidding is third tranche condition of PSRP</li> </ul>	None
	Privatize generation	<ul style="list-style-type: none"> <li>•No program yet</li> </ul>	<ul style="list-style-type: none"> <li>•Law to allow full privatization of ENEE</li> </ul>	<ul style="list-style-type: none"> <li>•Not under preparation</li> </ul>	Missing law to ENEE

	Issue	Program	Instruments	Current Status	Reforms pending termination of
Communications	Imprecise regulatory and legal framework	<ul style="list-style-type: none"> <li>•PSRP</li> <li>•MIF in advanced preparation</li> </ul>	<ul style="list-style-type: none"> <li>•Telecommunications Framework Law to change structure of HONDUTEL, create regulatory entity and allow private sector participation</li> </ul>	<ul style="list-style-type: none"> <li>•Law approved in 10/95 for first tranche of PSRP</li> <li>•New institutional arrangement to be supported by MIF</li> </ul>	None
	<ul style="list-style-type: none"> <li>- Deficient service and high unsatisfied demand</li> <li>- Low technical level of HONDUTEL and insufficient technical and financial capacity to operate an efficient service</li> <li>- Limited public resources to increase the capacity of the service</li> </ul>	<ul style="list-style-type: none"> <li>•PSRP</li> <li>•MIF in advanced preparation</li> </ul>	<ul style="list-style-type: none"> <li>•Telecommunications Framework Law</li> <li>•Creation of subsidiaries with participation and control of a private operator</li> <li>•Creation of the regulatory entity</li> </ul>	<ul style="list-style-type: none"> <li>•Law approved 10/95</li> <li>•New institutions supported by MIF</li> </ul>	None
Aeronautics	<ul style="list-style-type: none"> <li>- Inappropriate legal and regulatory framework</li> <li>- Dispersion of functions in different areas of the state and lack of coordination among them</li> </ul>	<ul style="list-style-type: none"> <li>•PSRP</li> </ul>	<ul style="list-style-type: none"> <li>•Law of Civil Aeronautics and law to modify the structure of the Honduran Airport entity and of air navigation services. This will allow the creation of a new commercial enterprise and a new regulatory entity</li> </ul>	<ul style="list-style-type: none"> <li>•The law is a second tranche condition of PSRP</li> </ul>	None
	<ul style="list-style-type: none"> <li>-Inadequate resource allocation for the sector's investments</li> <li>- Lack of application of efficient commercial practices</li> </ul>	<ul style="list-style-type: none"> <li>•PSRP</li> </ul>	<ul style="list-style-type: none"> <li>•Law of Civil Aeronautics and law to modify the structure of the Honduran Airport entity and of air navigation services</li> <li>•Give in concession two airports or airport services</li> </ul>	<ul style="list-style-type: none"> <li>•The law is a second tranche condition of PSRP</li> <li>•To be done in second and third tranches of PSRP</li> </ul>	None



	Issue	Program	Instruments	Current Status	Reforms pending termination of
Ture	Need to eliminate controls of grain marketing	•Agriculture Reform Loan, phase II (ARL)	•Liberalization of grain marketing	Done	None
	Lack of efficiency in BANADESA; portfolio too large and concentrated on big producers	•Agricultural Reform Loan, phase II	•Restructure and divest BANADESA	•Restructuring and divestiture advanced in first and second tranches  •To be completed in third tranche	None
	Deforestation and deficient forest management	•Agricultural Reform Loan, phase II	•Restructure State Forest Administration entity  •Implement forestry action plan	•Restructuring and divestiture advanced in first and second tranches  •To be completed in third tranche	None
	Problems with land titling	•Agricultural Reform Loan, phase II	•Implement land tenure plan	•To be completed in third tranche	None
	Inefficiency of the sector's administrative structure, excess personnel; lack of rationality in budget allocations	•Agricultural Reform Loan, phase II  •PSRP	•Restructure sector administrative scheme  •Implement Public Administration Plan	•Restructuring advanced in first and second tranches (ARL)  •To be completed in third tranche of ARL and PSRP	None
	Need to privatize technology transfer services	•Modernization of agriculture services	•To be defined	•Profile II in preparation	None

ANEXO I-3

Página 4 de 7

	Issue	Program	Instruments	Current Status	Reforms pending termination of
Water and Sanitation	Inadequate institutional and regulatory framework	<ul style="list-style-type: none"> <li>•Water and Sanitation Reform program with parallel TC</li> <li>•MIF</li> </ul>	<ul style="list-style-type: none"> <li>•Framework Law of Water and Sanitation</li> </ul>	<ul style="list-style-type: none"> <li>•Law being prepared</li> <li>•Program and TC in analysis phase. Approval in 96</li> </ul>	None
	<ul style="list-style-type: none"> <li>- Inefficient service, unsatisfied demand and low quality of water</li> <li>- Financial problems of public institutions in the sector (inadequate tariff structure, losses, partial billing)</li> <li>- Centralized administrative structure due to low capacity of Municipalities</li> </ul>	<ul style="list-style-type: none"> <li>•Water and Sanitation Reform program with parallel TC</li> </ul>	<ul style="list-style-type: none"> <li>•Municipal decentralization plan</li> <li>•Reform tariff structure</li> <li>•Institutional reform</li> </ul>	<ul style="list-style-type: none"> <li>•Program and TC in analysis phase. Approval in 96</li> </ul>	None
Financial Sector and Capital Markets	<ul style="list-style-type: none"> <li>- Insufficient development of market and high intermediation costs</li> <li>- Central Bank can establish restrictions that distort financial intermediation</li> </ul>	<ul style="list-style-type: none"> <li>•Multi sector Credit operation</li> </ul>	<ul style="list-style-type: none"> <li>•Law of financial institutions</li> </ul>	<ul style="list-style-type: none"> <li>•Law approved 10/95</li> </ul>	None
	Inefficient supervision of financial system	<ul style="list-style-type: none"> <li>•Multi sector Credit operation</li> <li>•MIF Technical Assistance</li> </ul>	<ul style="list-style-type: none"> <li>•Law of financial institutions</li> <li>•Strengthening of Superintendency of Banks and Insurance</li> </ul>	<ul style="list-style-type: none"> <li>•Law approved 10/95</li> <li>•MIF to be approved 1/96</li> </ul>	None
	Legal restrictions to the use of guarantees	<ul style="list-style-type: none"> <li>•No program foreseen</li> </ul>	<ul style="list-style-type: none"> <li>•Law of guarantees</li> </ul>	<ul style="list-style-type: none"> <li>•Not programmed</li> </ul>	Law of guarantees
	Incipient development of capital market and limited development of institutional investors	<ul style="list-style-type: none"> <li>•Investment Sector loan</li> <li>•USAID program and PSRP TC</li> </ul>	<ul style="list-style-type: none"> <li>•Law of capital markets</li> <li>•Law of insurance</li> <li>•Reform of the Pension System</li> </ul>	<ul style="list-style-type: none"> <li>•ISL (no FSO allocated)</li> <li>•Diagnostic study of pension system in preparation (USAID)</li> </ul>	All

	Issue	Program	Instruments	Current Status	Reforms pending termination of
	Inappropriate legal and regulatory framework	<ul style="list-style-type: none"> <li>•PSRP Technical Cooperation and</li> <li>•Health Sector Loan</li> </ul>	<ul style="list-style-type: none"> <li>•To be defined within PSRP and Sector loan</li> </ul>	<ul style="list-style-type: none"> <li>•Pending initiation of diagnostic study in PSRP</li> <li>•Implementation of legal and regulatory framework in HSL</li> </ul>	None
	Inadequate distribution of budgetary resources	<ul style="list-style-type: none"> <li>•PSRP</li> </ul>	<ul style="list-style-type: none"> <li>•Changes in budget structure</li> </ul>	<ul style="list-style-type: none"> <li>•Initiated in first tranche of PSRP. Continued in second and third tranches</li> </ul>	None
	Inadequate distribution of human resources	<ul style="list-style-type: none"> <li>•PSRP</li> <li>•Japan Technical Cooperation</li> <li>•Health Sector Loan</li> </ul>	<ul style="list-style-type: none"> <li>•Diagnostic studies in the TC of PSRP, Health Sector loan and Japan TC</li> </ul>	<ul style="list-style-type: none"> <li>•To be started with the PSRP</li> </ul>	To be determined
	Inadequate supply system	<ul style="list-style-type: none"> <li>•PSRP</li> </ul>	<ul style="list-style-type: none"> <li>•Create new Supply Unit</li> <li>•Develop supply system at regional level</li> </ul>	<ul style="list-style-type: none"> <li>•Included in PSRP</li> </ul>	None
	Need to update administrative structure	<ul style="list-style-type: none"> <li>•PSRP</li> <li>•Health Sector program</li> </ul>	<ul style="list-style-type: none"> <li>•Institutional restructuring plan</li> <li>•Basic health services restructuring</li> </ul>	<ul style="list-style-type: none"> <li>•To be developed in PSRP</li> <li>•To be developed in Health Sector loan</li> </ul>	None
	Centralized administrative structure	<ul style="list-style-type: none"> <li>•Health Sector loan</li> </ul>	<ul style="list-style-type: none"> <li>•Institutional reorganization at the local level with participation of private sector</li> </ul>	<ul style="list-style-type: none"> <li>•To be developed in Health Sector loan</li> </ul>	None

	Issue	Program	Instruments	Current Status	Reforms pending termination of
Education	-Efficiency problems reflected in high desertion in the basic cycle  - Low quality of human resources  -Inadequate school evaluation systems	•Basic Education Program of IBRD	•Pilot testing system •Teacher training •Library and didactic materials dotation	•IBRD program to start in 1996	None
	Low quality of intermediate and technical education	•PSRP •Intermediate Education and Professional Formation Program •MIF Program	•Reorganization of education system •Widen private sector participation	•To begin with second tranche PSRP •Continued with Intermediate Education and Professional Formation Program	None
	Technical education does not respond to private sector needs	•PSRP •Intermediate Education and Professional Formation Program •MIF Program	•Strategy to transfer technical education to private sector •Reform of INFOP •Participation of NGOs	•To begin with second and third tranches PSRP •Continued with Intermediate Education and Professional Formation Program	None
	Inadequate organic functional structure with duplication of functions	•PSRP	•Restructuring of the Ministry of Public Education (SEP)	•To begin with first tranche PSRP	None
	High degree of centralization	•PSRP •Intermediate Education and Professional Formation Program	•Plan for decentralization of activities toward Departmental Directorates	•To begin with third tranche PSRP •Intermediate Education and Professional Formation Program	None
	Inadequate distribution of budgetary resources within sector	•PSRP	•Budget reallocation towards primary education	•To begin with PSRP	None

	Issue	Program	Instruments	Current Status	Reforms pending termination of
	Existing restrictions in the formal labor market	•USAID program	•New labor code	•Draft reform of the labor code under discussion by government, unions and private sector	Pending approval of code by Congress
	Legislation not updated especially for current needs of trade and investment activities	•Justice Modernization Program •MIF  •USAID program	•Tribunal organization law •Constitutional norms •Civil procedure code •New commercial code •New legislation to favor investment  •Constitutional reform for election of magistrates	•Project in preparation; Board approval 1/96. •MIF approval first half of 96.  •Being done through USAID program	None
Private Sector	Deficiencies in property registries	•Possible USAID program	•Eliminate legal restrictions •Improve registration systems	•USAID program under definition	New registration system
Legislative	Legislative Power has organization and administration problems and insufficient technical and financial resources	•Legislative Reform Program	•To be defined	•Identification phase	To be defined

## FISCAL IMPACT

The data base used in estimates includes the recommended 1995 budget for each Ministry by program and type of expenditure, as obtained from the Statistics Office of the Ministry of Finance (SHCP), and from the budget outturns for each decentralized public agency, courtesy of the General Accounting Office. The information on employment and pay was obtained from the Civil Service Administration and the SHCP Statistics Office.

The estimates of fiscal savings are based on the implementation of a three-year program, and are contingent on rationalization measures at the macro- and micro-institutional levels, rationalization of employment, and privatization. With respect to institutional restructuring, the exercise encompasses the central government and four sectors of the decentralized government: namely, education, health and social services, infrastructure and communications, and natural resources. In all cases, the institutional restructuring estimates exclude savings deriving from reductions in permanent staff. Rationalization of employment encompasses the entire public sector and includes all planned reductions in permanent staff. The reform of public services covers telecommunications and airports. The exercise does not include estimates of savings and increases in efficiency resulting from the implementation of appropriate systems of financial management, procurement, and external and internal auditing and control. The overall impact of the reform corresponds to 2.5 percent of GDP. This will be very helpful in enabling the government to achieve the fiscal consolidation targets agreed upon with the IMF.

Table 1

Public sector reform measures	US\$ million	Fiscal impact (%)
<b>I. Reform/Privatization of public services</b>	<b>48.5</b>	<b>1.30</b>
1. Telecommunications	31.9	0.86
2. Civil aviation	16.6	0.44
3. Ports	n.a.	n.a.
4. Energy	1/	1/
<b>II. Administrative reform</b>	<b>44.0</b>	<b>1.20</b>
<b>A. Institutional restructuring (excluding employment)</b>	<b>10.8</b>	<b>0.29</b>
1. Ministry of Education	1.9	0.05
2. Ministry of Health	2.6	0.07
3. Ministry of Communications and Transport (excluding civil aviation)	2.3	0.06
4. Ministry of National Resources	0.4	0.01
5. Decentralized agencies	3.6	0.10
<b>B. Rationalization of employment</b>	<b>33.2</b>	<b>0.91</b>
<b>TOTAL</b>	<b>92.5</b>	<b>2.50</b>

1/ Calculation pending the results of the study being performed in the context of the energy sector program.

Source: Estimates by the mission in collaboration with sector consultants.

# I. Reform of public services

**Telecommunications.** The reform of the telecommunications sector could bring an increase in revenue from taxes (US\$29.1 million), dividends (US\$16.7 million), and imputed revenue equivalent to the amount of service on HONDUTEL's debt, which, if no reform were to occur, would have to continue to be paid (US\$7.3 million). The fiscal impact is based on conservative estimates of the value of the concessions. The final value would be determined on the basis of the going concern value of the services covered by the concession. This value would be determined by investor competition in the marketplace (see paragraphs 2.24 and 2.25). For the purposes of this analysis, an estimate of US\$440 million has been used, of which the government would receive US\$85 million net, which represents 50 percent of the net worth of HONDUTEL, at the difference between the value of the concessions and the outstanding debt of HONDUTEL, i.e., US\$270 million. Imputed revenue is calculated by taking account of the net revenue to be generated by the concessions for services and international interest rates (average). Impact is estimated as follows:

Table 2

Item	Amount US\$ million
Total revenue after privatization	53.1
5 percent tax on international calls	4.7
25 percent tax on profits	22.2
Import tax, etc.	2.2
Dividends on shares <sup>1/</sup>	16.7
Imputed income on sale, net <sup>2/</sup>	7.3
Current revenue	21.2
Central government	12.8
Other parts of government	1.4
Net investment financed by HONDUTEL	7.0
Net increase in revenue	31.9
As a percentage of GDP	0.9

- <sup>1/</sup> It is assumed that the subsidiaries distribute 50 percent of profits as dividends. The additional revenue in the amount of US\$16.7 million (portion of earnings retained by the Government of Honduras) is not included.
- <sup>2/</sup> It is postulated that the government would use the net proceeds of the concessions to repay other debts, which in turn would reduce debt service.

**Civil Aviation.** The annual fiscal impact of the reform is estimated at US\$16.6 million (net current losses plus estimated net revenue), attributable to the following: (a) the new institutional structure;

(b) revenue generated by new services; (c) the new tariff structure; and, (d) taxes payable by the new enterprise and by the consortium of private firms holding the concession. This is an underestimate, as it does not take into account the value of the gains in efficiency and the attendant increase in air traffic. Table 3 shows the estimated impact of the reform. The current operating costs are those incurred by the Civil Aviation Directorate (DGAC) and those operating costs that occur after the reform will be incurred in supporting the regulatory entities. The investment outlay is the average amount budgeted for civil aviation projects to be executed by SECOPT in 1994-1995. Such outlays would no longer be the responsibility of the central government and would be taken over by the new, privately operated enterprise. The enterprise's debt amounted to US\$93 million as at end-1994. Service on that debt in 1995 will be US\$4 million, and is expected to rise to US\$6.5 million in 1997. The revenue will be accounted for by: (a) airline ticket sales taxes, which are assumed to be constant; (b) user fees for airport facilities, which are currently collected by the government but which will be transferred to the new enterprise. The taxes levied on the new enterprise and the consortium of firms holding the concession reflect their income taxes as well as sales taxes on the services that they will provide.

Table 3

Fiscal Impact of the Civil Aviation Sector Reform		
Central government	Current amounts (US\$)	Amounts estimated with the reform (US\$)
<b>Expenditure</b>	<b>19.4</b>	<b>0.11</b>
Operating	1.2	0.11
Investment	14.2	0.0
Interest on debt	1.8	0.0
Debt repayment	2.2	0.0
<b>Revenue</b>	<b>7.6</b>	<b>5.0</b>
Airline ticket taxes	3.8	3.8
Taxes on services	3.8	0.0
Taxes levied on the enterprise	0.0	0.5
Taxes levied on concession-holders	0.0	0.7
<b>Outturn</b>	<b>-11.8</b>	<b>4.8</b>

Ports. The intended reforms in the ports sector are less ambitious in scope, and are limited to the preparation and startup of activities. Fiscal impact will be estimated once the reform has been implemented in its entirety.



Energy. A study is being carried out to calculate the value of the assets of the electric power company and to design the regionalization of power distribution. This study will lay the groundwork for estimating the fiscal impact of privatizing regional power distribution.

## II. Administrative reform

### Institutional restructuring

At the Ministry of Education, the US\$1.9 million in savings will be apportioned as follows: 23 percent on other personnel-related expenditure (excluding permanent employees), 50 percent on goods and services, 18 percent on transfers, and 8 percent on construction, deriving from the efficiency gains attributable to decentralization. With respect to employment rationalization, US\$0.9 million in additional savings will be achieved from cutting permanent positions.

At the Ministry of Health, the fiscal impact is US\$2.6 million and will be generated by the introduction of performance evaluation criteria and incentives, as well as improvements in hospital management. Of this amount, US\$2.1 million will come from cuts in goods and services and US\$0.5 million will come from transfers. Additional savings in the amount of US\$0.2 million will come from cuts in permanent positions covered by the employment rationalization measures.

Savings at the Ministry of Communications, Public Works, and Transport, excluding the decentralization of the Civil Aviation Directorate, amount to US\$2.3 million, and will come from reductions in expenditures on goods and services (US\$0.2 million), other personnel-related expenditures (US\$0.6 million), and the elimination of the postal service department which has now been superseded as a result of the establishment of HONDUCOR (US\$1.5 million). Under the heading of employment rationalization come additional savings of US\$3.4 million from cuts in permanent positions.

At the Ministry of National Resources, the US\$0.4 million in savings will come from reductions in other personnel-related expenditure. The employment rationalization measures will include additional savings in the amount of US\$1 million to be obtained from reductions in permanent staff.

Within the decentralized government, the biggest savings come from liquidating JNBS and PANI and establishing a new and more efficient institution to deal with family-related issues operating with a reduced staff (500), as well as one enterprise to administer the national lottery with a staff of 100 (US\$2.2 million in savings). Additional savings will be obtained from the elimination of government transfers to the postal enterprise HONDUCOR, the streamlining of INA, the elimination of the Honduran Agricultural Marketing Institute, the transfer of IHCAFE to the private sector, the recentralization of IHRM, and the rationalization of EDUCREDITO.

### Employment rationalization

With respect to employment rationalization, the fiscal savings include the salaries of permanent employees as well as benefits such as year-end bonuses. The estimate excludes personnel providing services in the areas of health and education.

Within the central government, employment rationalization includes specific objectives for each Ministry, in line with the agreements reached with each minister and incorporated into the respective institutional restructuring plans.

Within the decentralized government, all institutions are legally obligated to reduce their staffing levels by 10 percent. The figure used here was the amount required by law, i.e., US\$13 million.

### Additional comments

The benefits accruing from the institutional restructuring process will be permanent benefits, since once the operations of the various ministries has been rationalized, the resulting efficiency gains will be of a long-term nature. In particular, the reduced investment planned for the civil aviation sector, equivalent to US\$14.2 million, is accounted for by the fact that the comparative neglect of the civil aviation sector in recent years has caused extensive deterioration within the sector. According to the authorities, it will be necessary to make a minimum and ongoing annual investment equivalent to this particular amount in order for civil aviation to operate efficiently and in accordance with required safety standards. As the new legislation on civil aviation makes provision for private sector investment by granting concessions for all commercial services (platform services for aircraft, management of cargo and passenger terminals, shops and other businesses, and land adjoining the runway area and the airport itself), incentives will be provided to ensure that the necessary investments are made by the private sector. It follows that such activities will no longer be in public hands.

With respect to employment rationalization, the analysis does not take into account the additional costs entailed by staff cuts, because the authorities have not provided for additional incentives to help obtain such reductions, which, incidentally, were mandated by law in October 1995. In addition, although it is clear that there will be some additional costs (severance, etc.), these will not be significant given the low pay levels involved.

For purposes of comparing the impact of the program with the impact of a loan from the two Banks, calculations were performed to determine the net present value of the annual flow of fiscal savings generated by the implementation of the public sector reform program over a time span of

10 years <sup>1/</sup>. These calculations yield a figure of US\$298 million. It follows that there are clear advantages to implementing the public sector reform program, for the resulting benefits will exceed the costs of the program and the technical cooperation funding, which will amount to US\$224 million (IDB and World Bank).

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<sup>1/</sup> The calculations are based on a discount rate that reflect the opportunity cost of the funds (12 percent).

**POSSIBLE USES OF THE PROCEEDS FROM THE PRIVATIZATION OF HONDUTEL 1/**

The privatization of the telecommunications enterprise (HONDUTEL) is a key element in the State modernization program in Honduras. Its estimated selling value is US\$440 million. Once HONDUTEL's debt (US\$270 million) has been deducted, the government will receive US\$85 million (50 percent of the net value of HONDUTEL), and the amount remaining will be used as capital for the enterprise that is to replace HONDUTEL (HONDUCOM). Purely by virtue of the fact that the Government will be eliminating 50 percent of HONDUTEL's debt, the external public debt will be reduced by approximately eight percentage points of GDP. By the same token, Honduras will increase its reserves by US\$85 million.

The proceeds of the privatization are now expected to become available in the first half of 1997. Accordingly, possible future uses of these proceeds (2.6 percent of GDP) fall into the following categories.

A) Repayment of nonconcessional external debt. The external debt at end-1994 amounted to US\$4,172 million. Of this sum, 52 percent is owed to multilateral organizations; 34 percent is owed to bilateral organizations; and 8 percent is private debt. Of the multilateral debt, approximately US\$1.2 billion is on market terms. The interest rate on the nonconcessional debt is, on average, nine percent in nominal terms (six percent in real terms).

If the government earmarks the proceeds from privatization for repayment of nonconcessional external debt, it will reduce the total debt stock by two percent and therefore ease the interest pressure on government revenue accounts and the balance of payments. The effect on the economy could be very noticeable if it thus becomes possible to pay off project debts carrying financial terms similar to those applicable to the El Cajón reservoir loan (basket of currencies), if the private debt is bought back on the secondary market at a substantial discount, or if Honduras is able to coordinate international assistance to complement its debt reduction efforts and manages to settle a goodly portion of its more expensive debt and to reschedule the long-term debt stock, thereby easing the severe pressure generated by the service on such debt.

The most burdensome category of multilateral debt is the debt owed to CABEI. This is partly because the maturities for repaying the principal on the debt are shorter, but also because the interest rates are higher. By way of illustration, in 1994 the total service on the external debt amounted to US\$391 million (cf., Annex I-2, Table 3), of which US\$81 million went to CABEI, as a result of which CABEI became the second largest creditor (after the World Bank) and now held first place in terms

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1/ The analysis is based on a conservative estimate that places the selling price of HONDUTEL at US\$440 million.

of receiving principal repayments. If the government succeeds in establishing a fund with the proceeds from the privatization and is able to supplement this fund with international support, it could then pay off a significant portion of its debt to CABEI and reschedule the longer-term debt stock on more favorable terms (through zero coupon bond swap transactions, for example). In this way, after one year Honduras would recoup the amount spent as it would no longer be paying about US\$80 million per annum on average by way of service on the debt.

B) Repayment of domestic debt. The domestic debt amounts to L\$3,660 million (US\$390 million as at February 1995); this represents 13 percent of GDP and the service on the debt absorbs 3.2 percent of GDP. Forty percent of the debt is vis-à-vis the Central Bank (US\$155 million) while 44 percent is owed to commercial banks. The average interest rate in 1994 was approximately 20 percent, and the marginal rate applicable to new monetary absorption certificates (having maturities of less than one year) was 32 percent in June 1995, which represents 6-7 percent in real terms (projected inflation for 1995 is 25 percent).

The revenue generated by the privatization would represent 21 percent of the domestic debt. It follows that final decisions regarding the use of such revenue will hold major implications for the conduct of macroeconomic policy.

If the privatization revenue is used to reduce the debt owed to the Central Bank, the conduct of monetary policy would not be affected because the resources in question would be immediately sterilized. Because the domestic debt stock would be reduced by 21 percent, the need to obtain additional funds to pay the interest on the existing debt and to retire that debt (which would be achieved through the placement of new bonds) would be reduced while giving the government greater flexibility in the area of monetary management. Furthermore, this would help to eliminate additional pressure on the interest rate and reduce the need to compete with the private sector for financial resources.

If, as an alternative, the proceeds from privatization were used to reduce the debt with commercial banks, this would have the effect of giving greater liquidity to the private sector. However, with a larger volume of financial resources entering the economy — partly as a result of the windfall coffee earnings (expected to continue into 1996) and partly as a result of the continuation of the program, agreed upon with the IMF, for reducing the reserve requirement (to 12.5 percent in June 1996) — it ought to be borne in mind that if the commercial debt were to be repaid, additional pressure would then be placed on the inflation rate and serious problems would arise in the conduct of monetary policy as the Government would have to engage in open market operations to mop up the increased liquidity and would need to offer higher interest rates in order to be able to place government securities. This in turn would lead to higher inflation; it would also act as a disincentive to productive investment, and would adversely affect the government revenue accounts.

Increased inflation would further overvalue the currency unless exchange policy measures were adopted.

Empirical evidence in 1995 bears out the foregoing conclusions. The gradual reduction in the reserve ratio from 40 percent in December 1994 to 35 percent in June 1995, and the windfall earnings resulting from coffee sales, are putting severe pressure on the inflation rate, which had initially been estimated at 12 percent, but which is expected to reach 25 percent by year-end. Compounding matters further is the fact that the monetary absorption certificates, despite their high rate of return, have not been well received, partly because of the lack of credibility of economic policy and partly because exchange policy was used unsuccessfully as an anti-inflationary policy, which in turn has overvalued the currency and has led to expectations that there is likely to be a sizable devaluation.

Conclusions. Privatization in and of itself will have a beneficial effect on the balance of payments in the sense of reducing the stock of debt and debt service, and it will also have a beneficial effect on the government revenue accounts while helping to build up international reserves. Final decisions as to the use of privatization revenue should take into account the monetary policy repercussions which such decisions are likely to have. Accordingly, given that the funds in question are now expected to become available in 1997, an election year, earmarking the proceeds from privatization for repayment of domestic debt owed to the Central Bank would appear to be the wisest decision as it would not affect the conduct of monetary policy, would not needlessly increase the liquidity present within the economy, would not put additional pressure on inflation, and would ease the interest pressure on the government revenue accounts, while reducing the amount of future bond placements required to redeem government securities. However, repaying the external debt would also have major repercussions on the government revenue accounts and on the balance of payments, particularly if the government were able to form an international support group to complement domestic resources to establish a fund to repay Honduras' most expensive debt (CABEI) or to reschedule it with longer maturities and on more favorable terms.

**PUBLIC SECTOR REFORM SUPPORT PROGRAM**

(CT/HO-0101)

**EXECUTIVE SUMMARY**

**BORROWER AND GUARANTOR:** Government of Honduras

**EXECUTING AGENCY:** The Presidential Commission on Modernization of the State and the Ministry of Finance

**AMOUNT AND SOURCE:**

IDB:	US\$ 5.0 million (SF)
IDA:	US\$ 9.6 million
Local contribution:	US\$ 2.1 million
Total:	US\$16.7 million

**TERMS AND CONDITIONS:**

Amortization period:	40 years, including a 10-year grace period
Disbursement period:	48 months
Interest rate:	1% during the grace period; 2% for the remaining 30 years
Inspection and supervision:	1%
Credit fee:	0.5%

**OBJECTIVES:** Execution of the public sector reform program, hereafter called the reform program, will be supported by this parallel technical cooperation, whose specific objective is to help the Government of Honduras to complete the design and execution of reform activities provided for in the state modernization program, strengthen the administrative capacity of the agencies involved in the process, and support compliance with the conditions for the public sector reform program.

**DESCRIPTION:** The technical cooperation funding will be used to support the public sector reform program and state modernization activities which the Government of Honduras is carrying out, through preparation and implementation of the following components: (i) reform of public services; (ii) institutional restructuring; (iii) human resource management; (iv) integrated financial management and investment programming; (v) procurement and contracting; (vi) the Social Security Institute and social security system; (vii) environmental strengthening; and (viii) coordination and monitoring.

<b>ENVIRONMENTAL CLASSIFICATION:</b>	The Environment Committee, at its meeting of May 11, 1995, classified this as a Category II operation.
<b>BENEFITS:</b>	With this cooperation, the Presidential Commission on Modernization of the State, the Ministry of Finance, and the ministries and executing agencies directing or implementing the reforms included in the program will be strengthened. This will lead to timely execution, technically supported by the decision-making process and compliance with the conditions set out in the public sector reform program, and will support the preparation of additional state modernization program activities.
<b>RISKS:</b>	<p>The risks that could affect achievement of the technical cooperation objectives relate to those of the public sector reform program it seeks to support, the most important being difficulties that could arise in coordination and monitoring, given the many institutions to participate in the reform. To mitigate this risk during execution, a coordinating unit will be created within the Presidential Commission, the Consultative Commission on Privatization will be strengthened, and temporary modernization units will be set up in the agencies concerned (see chapter III). In addition, this cooperation will finance the hiring of a senior specialist with experience in programs of this nature to work for a total of one year in short stints, to monitor the technical cooperation and the program.</p> <p>The second risk is the probable lack of trained personnel to carry out the reforms. This risk would be reduced by strengthening the commissions and modernization units, with technical teams of national and international consultants by area of specialization for each component and with training programs for the various components.</p>
<b>THE BANK'S COUNTRY STRATEGY:</b>	The Bank's strategy for Honduras seeks: (i) to eliminate financial constraints by supporting programs to restore the government to a sound footing; (ii) to make investment more productive by supporting programs in privatization, promotion of private investment, improvement of government efficiency, and promotion of exports and work training; and (iii) to develop human capital by promoting social projects.
<b>SPECIAL CONTRACTUAL CONDITIONS:</b>	Conditions prior to the first disbursement of technical cooperation funding: (a) have placed in operation the program coordinating unit within the Presidential Commission for Modernization of the



State, and the modernization units in the Ministries of Education; Health; Natural Resources; Communications; Public Works and Transport; Economic Affairs and Trade; and Finance, and have equipped them with the staff and logistical support needed for operation; (b) have hired (i) the chief, consultant-monitor and financial and accounting manager of the PCU and the national consultant in institutional reform; and (ii) the chiefs of the modernization units, in accordance with Annex C to the contract; (c) have presented to the Banks: (i) the strategic plan for procurement of computer systems for the program; and (ii) basic programs to implement the program by component; and (d) have placed in effect the coordination procedures with the institutions referred to in paragraph 3 of the contract.

## **I. BACKGROUND AND OBJECTIVES**

- 1.1 The government is implementing a broad state modernization program (PME), aimed at reducing the government's size, giving greater participation to the private sector, eliminating duplicate or unnecessary institutions or functions, improving public sector efficiency and giving the private sector a larger role in activities that it can perform more efficiently. The PME will be supported technically and financially by the IDB and the World Bank under a public sector reform program and this parallel technical cooperation project.
- 1.2 The objectives of the technical cooperation are to assist the Government of Honduras in preparing and implementing the reforms and strengthening the capacity to execute and meet the conditions set out in the public sector reform program. In addition, it will give technical support to defining the PME's future activity, since its complexity and broad scope require timely support for effective execution.
- 1.3 During preparation of the program the IDB and the World Bank agreed that, using funds from the advance provided under the World Bank PPF, and charged to this technical cooperation, support would be provided to the government to begin the reforms. The IDB also provided support for preparation using consulting funds from Region 2. The following activities have taken place thus far: (a) preparing institutional restructuring plans, including employment reduction goals; (b) formulating a new draft of the Public Administration Act; (c) designing the institutional restructuring reforms; (d) strengthening the technical capacity of agencies to implement priority programs; (e) strengthening the Presidential Commission's

capacity to guide, monitor, and control institutional restructuring efforts; (f) preparing an actuarial financial study with recommendations on contributions to the Honduran Social Security Institute (IHSS); (g) designing a computerized user record system and a program to improve the IHSS's administrative and financial administration; (h) designing and developing an integrated system for personnel and payroll administration for the civil service and related systems; (i) formulating a plan of action to reform the teacher employment and pay systems; (j) designing an integrated financial administration and investment planning system; (k) designing a modern procurement system to allow decision-making and competition to be decentralized, and preparing amendments to the new procurement legislation to be prepared; (l) preparing a strategy to develop a modern, effective internal auditing system; (m) developing a strategy to allow private involvement in HONDUTEL and preparing a framework law for the sector; and (n) preparing Tax Code reforms and coming up with a plan to streamline export incentives, specifying the control responsibilities of the central ministries.

## II. THE PROGRAM DESCRIPTION

- 2.1 To achieve the objectives of the public sector reform program and supplement the efforts begun, this parallel technical cooperation supports the development of the following components:
  1. Reform of public services
  2. Institutional restructuring
  3. Human resources management
  4. Integrated financial management and investment programming
  5. Procurement and contracting
  6. Social Security Institute and social security system
  7. Environmental strengthening
  8. Coordination and monitoring
- 2.2 These components will be financed largely by the IDB and the World Bank. Component 6 will be financed by the World Bank alone, and component 7 by the IDB alone. In addition to the World Bank co-financing, local counterpart funding will be made available.
- 2.3 For component 1, the operation will be supplemented by a MIF technical cooperation project for the restructuring and promotion of private sector participation in the electricity and telecommunications sectors (TC-95-03-05-5). The aim is to support necessary action to establish stable, transparent regulatory frameworks and strengthen the regulatory capacity of autonomous and independent bodies in each of the sectors.

1. Public services reform component

- 2.4 Because the public sector carries out activities which could be provided more efficiently by the private sector, the reform program objectives include leveraging private sector resources to invest in and operate the services.
- 2.5 The technical cooperation's objective in this component is to assist in preparing technical studies and implementing needed reforms, and in fulfilling the program conditions in the areas of telecommunications, ports and civil aviation.

a. Reform of the telecommunications subsector

- 2.6 The aim is to prepare the technical and legal ground for reforming the telecommunications sector and allow participation by the private sector. Using PPF funds, consulting services were hired to help the Consultative Commission on Privatization prepare a strategy to make the sector more efficient, reform HONDUTEL, and promote private sector participation, including draft legislation and changes to the legal framework for telecommunications and amendments to the HONDUTEL charter. The activities to be supported in the future using this technical cooperation funding are:
- (i) marketing the transaction;
  - (ii) designing the investments and determining the service quality obligations of the new operator;
  - (iii) preparing an inventory and valuation of assets and liabilities;
  - (iv) repeating the audit and restating the financial statements of HONDUTEL pursuant to U.S. generally accepted accounting principles;
  - (v) preparing financial projections for the new corporation(s);
  - (vi) determining the initial worth of the new company(ies);
  - (vii) preparing and negotiating the legal documentation for the transaction; and
  - (viii) carrying out the international competitive bidding process.
- 2.7 The above-mentioned MIF funds will be used to put in place the legal framework and regulations governing the autonomous regulatory body and to create CONATEL and start up its operations.

b. Restructuring of the civil aviation subsector

2.8 The objective of this component of the technical cooperation is to strengthen the government's institutional and financial capacity and support the continued implementation of subsector reform initiated under the IDA transport sector rehabilitation project. The following activities are included:

- (i) Prepare regulations to accompany the Civil Aviation Act and the National Airports and Air Services Company Act, and the standards and procedures needed for implementation pursuant to international codes and law;
- (ii) Support the creation of an autonomous regulatory body for the subsector;
- (iii) Assist in the creation of the public company to operate the airports and air services;
- (iv) Assist in the granting of concessions to private operators for commercial activities and airport services;
- (v) Prepare procedures for recruiting staff in the subsector; and
- (vi) Design and carry out a staff training program on the subsector's technical and administrative functions.

c. Restructuring of the ports subsector

2.9 The objective of the technical cooperation is to spark private sector interest in port operations and support implementation of the reform actions. The following activities are included:

- (i) Prepare a strategy containing an assessment of the impact of private sector participation in port operations, and the effect on the National Port Authority (ENP);
- (ii) Develop policies and define the role of private sector operators in Puerto Cortés and other ports;
- (iii) Assist in defining the institutional role of the ENP;
- (iv) Advise on the ENP restructuring; and
- (v) Develop mechanisms for participation by private sector operators.

2.10 Cost

Table 2.1  
Budget of the Public Services Reform Component  
(in US\$000s equivalent)

Category of investment	IDB	IDA	LOCAL	TOTAL
1. Consulting firms	216.0	2,116.0	0.0	2,332.0
2. International consultants	405.0	144.0	0.0	405.0
3. National consultants	344.4	0.0	0.0	488.4
4. Training	100.0	0.0	0.0	100.0
5. Equipment	40.0	0.0	0.0	40.0
6. General support	0.0	0.0	400.0	400.0
7. PPF-IDA financing	0.0	40.0	0.0	40.0
<b>TOTAL</b>	<b>1,105.4</b>	<b>2,300.0</b>	<b>400.0</b>	<b>3,805.4</b>

2. Institutional restructuring component

- 2.11 The technical cooperation's objective in this component is to support the preparation and implementation of the institutional restructuring programs (PRIs) for agencies selected according to their priority, as contained in the state modernization program.
- 2.12 With the assistance of the consulting services financed with the PPF advance and IDB consulting funds, the government prepared the PRIs, including employment reduction objectives for implementation of the administrative reform program. Institutional restructuring plans were begun in four ministries (Education, Natural Resources, Justice and the Interior, and Foreign Affairs), and progress was achieved in Communications, Public Works and Transport, Health, and Labor. With regard to the decentralized administration, plans of action were approved to: (a) convert the JNBS to the Institute of the Family and Child and PANI to the National Lottery Company; (b) financially reform the IHSS; (c) transfer IHCAFE to the private sector; (d) recentralize the IHRM's functions to the Ministry of Health; and (e) incorporate into the FHIS small and medium-sized construction activities which are still the responsibility of the SEP, SSP, SGJ, and CONAPID.
- 2.13 The draft of the new general public administration law was also prepared. The bill lays down the structure and composition of the central and decentralized administration, including mechanisms for the elimination, transfer and privatization of agencies and sets

out standards of transparency and accountability for public administration, especially for financial and human resources.

2.14 The activities to be financed with this cooperation in the future are:

- a. prepare institutional restructuring plans (PRIs) for additional agencies, including EDUCREDITO, INFOP, FHIS and IHCAFE;
- b. implement the PRIs in priority ministries: Education, Health, Communications, Public Works and Transport, Natural Resources, Economic Affairs and Trade, Finance, and the Institute of the Family and Child;
- c. strengthen the capacity of the agencies to design and implement priority programs, including design of standard procedures and training;
- d. assist in the improvement of the existing legal instruments and the development of such new ones as are required;
- e. provide training courses; and
- f. follow up on the action plans agreed upon.

2.15 Cost

Table 2.2  
Budget of the Institutional Structuring Component  
(in equivalent US\$1,000s)

Category of investment	IDB	IDA	LOCAL	TOTAL
1.0 Consulting firms	300.0	0.0	0.0	300.0
2.1 International consultants	315.0	54.0	0.0	369.0
2.2 National consultants	457.2	63.6	0.0	520.8
3.0 Training	100.0	0.0	0.0	100.0
6.3 Equipment	150.0	0.0	0.0	150.0
6.0 General support	0.0	0.0	241.0	241.0
PPF-IDA financing	0.0	142.0	0.0	142.0
<b>TOTAL</b>	<b>1,322.2</b>	<b>259.6</b>	<b>241.0</b>	<b>1,822.8</b>

3. Human resources management component

- 2.16 The technical cooperation's objective in this component is to lay the groundwork for the rationalization of the employment and pay regime as defined in the administrative reform of the state modernization program, and to assist in improving the administration of human resources and control of expenditure. Using the PPF advance and IDB consulting funds, the government designed an improved personnel data base for the civil service and related systems, and has begun to operate the system. Terms of reference were also prepared for formulation of a plan of action for a reform of teachers' employment and salaries.
- 2.17 The activities to be financed hereafter are:
- a. systematic monitoring of public sector payroll and pay regimes in the executive branch;
  - b. design and implementation of a system of ongoing census followup and payment audits;
  - c. continued implementation of an integrated human resources management system for the civil service and related regimes, and integration of the payroll system with the budget;
  - d. development and implementation of a budget-linked integrated human resources management and payroll system for the remaining employment and pay regimes in the executive branch;
  - e. extension of the integrated human resources management and pay systems to all the ministries and at least four decentralized institutions, calling for consulting services, computer systems, systems development, computer packages and training;
  - f. design of a strategy to improve the civil service regime from a regulatory, institutional and operational standpoint, including recommendations on the structure of similar regimes;
  - g. design of an updated human resources policy, including recruitment procedures;
  - h. amendments to the Civil Service Act as necessary;
  - i. strengthening of the institutional capacity of DGSC and the ministries in the field of human resources management;
  - j. assistance to SEP to improve its ability to estimate teaching staff requirements; and
  - k. assistance to SSP to assess the availability of human resources, training, development, mobilization and staff performance.

2.18 Cost

Table 2.3  
Budget of the Human Resources Administration Component  
(in equivalent US\$1,000s)

Category of investment	IDB	IDA	LOCAL	TOTAL
1.0 Consulting firms	255.0	255.0	0.0	510.0
2.1 International consultants	126.0	126.0	0.0	252.0
2.2 National consultants	154.8	347.2	0.0	502.0
3. Training	120.0	120.0	0.0	240.0
6.3 Equipment	600.0	0.0	0.0	600.0
6.0 General support	0.0	0.0	320.0	320.0
PPF-IDA financing	0.0	185.0	0.0	185.0
<b>TOTAL</b>	<b>1,255.8</b>	<b>1,033.2</b>	<b>320.0</b>	<b>2,609.0</b>

4. Integrated financial administration and investment planning component

2.19 The technical cooperation's objective in this component is to support implementation of an integrated financial management system and an investment programming system within a new institutional framework. This will bring greater participation, autonomy and accountability by public entities in budget planning and execution. In addition, it will introduce performance incentive and evaluation systems. Using PPF financing and IDB consulting funds, an analysis of the current situation was carried out and recommendations were prepared in this area, on which basis the government is designing the integrated financial management system and investment programming.

2.20 The technical cooperation will give support to the following activities in the future:

- a. developing and implementing an integrated financial management system, linked to human resources management and the payroll system;
- b. continue supporting the development and implementation of the investment programming system, which has received support from the IDB and the United Nations;



- c. developing modern methods and procedures to support fundamental financial management functions;
- d. developing a strategy to improve and restructure the institutional framework for financial management and investment programming;
- e. monitoring, on the basis of the plan of action agreed, updating of the integrated financial management and investment programming system;
- f. designing and implementing a technical staff training system in each public body and in agencies responsible for financial administration and the public investment program;

## 2.21 Cost

Table 2.4  
Budget of the Integrated Financial Administration  
and Investment Planning Component  
(in US\$000s equivalent)

Category of investment	IDB	IDA	LOCAL	TOTAL
1.0 Consulting firms	0.0	648.0	0.0	648.0
2.1 International consultants	144.0	549.0	0.0	693.0
2.2 National consultants	124.0	346.4	0.0	470.4
3.0 Training	140.0	260.0	0.0	400.0
6.3 Equipment	0.0	1,650.0	0.0	1,650.0
6.0 General support	0.0	0.0	570.0	570.0
PPF-IDA financing	0.0	60.0	0.0	60.0
<b>TOTAL</b>	<b>408.0</b>	<b>3,513.4</b>	<b>570.0</b>	<b>4,491.4</b>

## 5. Procurement and contracting component

- 2.22 The technical cooperation's objective in this component is to support the implementation of a new public procurement system. Using the PPF advance and IDB consulting funds, a modern procurement system was designed and approved which decentralizes responsibility and operating capacity to units within each public entity, and amendments to the new public procurement legislation were prepared to reform the current system and simplify administration rules and procedures.

2.23 Support will be provided under the technical cooperation for:

- a. developing transparent, simple administrative procedures for procurement and establishing registration, organization and control methodologies within the new legal framework;
- b. strengthening the skills of the personnel of the centralized and decentralized bodies responsible for procurement and bid evaluation; and
- c. implementing coordination and communication mechanisms between the units responsible for procurement and the regulatory unit; and
- d. holding seminars on the legal and institutional framework and its effect on operating procedures.

2.24 Cost

Table 2.5  
Budget of the Procurement and Contracting Component  
(in US\$000s equivalent )

Category of investment	IDB	IDA	LOCAL	TOTAL
2.1 International consultants	0.0	108.0	0.0	108.0
2.2 National consultants	0.0	103.2	0.0	103.2
3.0 Training	0.0	150.0	0.0	150.0
6.3 Equipment	50.0	0.0	0.0	50.0
6.0 General support	0.0	0.0	50.0	50.0
PPF-IDA financing	0.0	11.0	0.0	11.0
<b>TOTAL</b>	<b>50.0</b>	<b>372.2</b>	<b>50.0</b>	<b>472.2</b>

6. Social Security Institute and social security system component

- 2.25 The technical cooperation's objective in this component is to support the government in developing a strategy for modernizing the social security system and reform of the pensions system.
- 2.26 Using PPF funding, the government determined the actuarial base for the IHSS pension and health funds and the plan of action for its reform. The design of a membership and payment system and the

identification of IHSS beneficiaries are now under way. The technical cooperation will give support for:

- a. assisting in the development and implementation of the IHSS system in the areas of programming, budgets, billings, payments, inventories, current accounts of beneficiaries and contributors, and administration;
- b. assisting in the updating of IHSS accounts and member registration;
- c. training of IHSS administrators and technical staff;
- d. consulting for a diagnostic study of the pension and health care systems;
- e. preparing a cost analysis of the current and future social security systems; and
- f. preparing strategies to reform the pension and health care systems and developing a workmen's compensation system.

## 2.27 Cost

Table 2.6  
Budget of the Social Security Institute and  
Social Security System Reform Component  
(in US\$000s equivalent)

Category of investment	IDB	IDA	LOCAL	TOTAL
1. Consulting firms	0.0	543.0	0.0	543.0
2. National consultants	0.0	0.0	0.0	0.0
3. Training	0.0	0.0	0.0	0.0
4. Equipment	0.0	558.0	0.0	558.0
5. General support	0.0	0.0	157.0	157.0
6. PPF-IDA financing	0.0	18.0	0.0	18.0
<b>TOTAL</b>	<b>0.0</b>	<b>1,119.0</b>	<b>157.0</b>	<b>1,276.0</b>

## 7. Environmental strengthening component

- 2.28 The Bank has supported efforts by governments in the area to achieve sustainable development in Central American societies, and has undertaken to support the Alliance for Sustainable Development

signed by the Central American presidents and the Prime Minister of Belize.

- 2.29 The instruments available to the Alliance are as follows: (1) the National Council for Sustainable Development (CONADES), representing the public sector and civil society; and (2) the Central American Council for Sustainable Development. In pursuance of its commitments under the Alliance, Honduras created CONADES by Executive Decree CM-14-94 of October 19, 1994.
- 2.30 The purpose of this component of the technical cooperation is to strengthen CONADES technically and logistically, along with the environmental units in SECOPT, SEP and SSP. Support will be provided for the following activities:
- a. prepare a strategic action plan for institutionalizing CONADES among the decision-making bodies of the State and setting priorities for activities key to sustainable development;
  - b. establish mechanisms for coordination with state, municipal and civil society organizations in policy-setting, planning, and execution and supervision of programs and projects under the Alliance;
  - c. set up an information system to inform decision-makers on fulfillment of commitments under the Alliance and under conventions and treaties in connection with the conservation of natural resources and biological, ethnic and cultural diversity;
  - d. establish, in coordination with the public sector investment system (SISPU) and within the appropriate organization, environmental criteria and standards for the national programs and projects under the Alliance;
  - e. prepare organization and personnel manuals in the environmental units;
  - f. prepare manuals of environmental procedures (audits, supervision, reports, terms of reference for environmental impact assessments, etc.) within the sphere of competence of each environmental unit; and
  - g. offer training courses to staff in the units.

2.31 Cost

Table 2.7  
Budget of the Environmental Strengthening Component  
(in US\$000s equivalent)

Category of Investment	IDB	IDA	LOCAL	TOTAL
1. Consulting firm	54.0	0.0	0.0	54.0
2. National consultants	27.8	0.0	55.0	82.8
3. Training	25.0	0.0	15.0	40.0
4. Equipment	60.0	0.0	35.0	95.0
5. General support	0.0	0.0	50.0	50.0
6. PPF-IDA financing	0.0	0.0	0.0	0.0
<b>TOTAL</b>	<b>166.8</b>	<b>0.0</b>	<b>155.0</b>	<b>321.8</b>

8. Coordination and monitoring component

- 2.32 Part financing was provided for the PCU using PPF funds in order to carry out the initial program actions. During execution, the technical-cooperation funds will be used to support consolidation of the PCU and the other executing agencies according to the execution arrangements described in section III, with respect to support for consulting, equipment and training.

2.33 Cost

Table 2.8  
Budget of the Coordination and Monitoring Component  
(in US\$000s equivalent)

Category of investment	IDB	IDA	LOCAL	TOTAL
2.1 International consultants	146.3	114.7	0.0	261.0
2.2 National consultants	269.7	407.7	0.0	677.4
3.0 Training	25.0	82.7	0.0	107.7
6.3 Equipment	43.0	0.0	0.0	43.0
6.0 General support	0.0	0.0	157.0	157.0
PPF-IDA financing	0.0	81.0	0.0	81.0
<b>TOTAL</b>	<b>484.0</b>	<b>686.1</b>	<b>157.0</b>	<b>1,327.1</b>

### III. EXECUTION AND FOLLOW-UP

- 3.1 The Bank's funding will be used in its entirety by the borrower, the program will be executed through: (i) the Presidential Commission on Modernization of the State (CPME), through the program coordinating unit (PCU) in its Executive Secretariat; and (ii) the Ministry of Finance (SHCP), through the Executive Secretariat of the Consultative Commission on Privatization (CCP).
- 3.2 The SHCP will execute the public services reform component with participation from the following institutions: HONDUTEL, SECOPT, and ENP. The CPME will execute the following components: (i) the institutional reform component, with SEP, SRN, SSP, SECOPT, SEC and SHCP; (ii) the human resources management component, with SHCP, the Ministry of the Office of the President through its Civil Service Directorate (DGSC), SEP and SSP; (iii) the integrated financial management and investment programming component, with SHCP; (iv) the procurement and contracting component, with SHCP; (v) the social security systems reform component, with CPME and IHSS; (vi) the environmental strengthening component, with CPME; and (vii) the program coordination and follow-up component, with CPME and CCP.
- 3.3 The activities under the public services reform component referred to in subsection (b) above will be supervised by SHCP in coordination with CPME, as indicated in section III of Annex A to the contract. The activities under the components referred to in subsections (i) through (vi) will be coordinated by CPME.
- 3.4 With support from this technical cooperation program, a program coordinating unit (PCU) will be created within the CPME Executive Secretariat, with a chief and five senior specialists in charge of the following areas: (i) institutional reform and environmental strengthening; (ii) pay and employment reform and information program; (iii) accounting and financial management of the public sector reform program and this technical cooperation program; (iv) management of consultant selection and hiring, and of the procurement of goods for components under CPME responsibility and the procurement and contracting component; and (v) integrated financial management and investment programming and IHSS. The CCP Executive Secretariat, which will support SHCP in carrying out the public services reform program, will be reinforced with two senior technicians in charge of privatization and granting of concessions for port and airport services. All the above-mentioned institutions will be strengthened with the assistance of national and international consultants.
- 3.5 The execution of the public sector reform program will be monitored by a consultant with extensive experience in programs of this nature. This consultant will be hired for short periods adding up

to one year, based on terms of reference agreed upon in advance with the Bank, and will work on a full-time basis.

- 3.6 A temporary modernization unit will be created under the program in SEP, SSP, SRN, SECOPT, SHCP and SEC, with support from a small group of full-time technical professionals whose chief will serve as counterpart to the PCU. This arrangement is intended to allow each agency to participate in the design, programming, execution and supervision of the reforms.
- 3.7 CPME and SHCP, as executing agencies, in addition to carrying out and coordinating the activities for which they are responsible under this program, will be in charge of selecting and hiring consultants and procuring equipment for the components under their responsibility as detailed in paragraph 3(b) of the preamble to the Special Conditions of the contract. CPME may delegate the latter duties to the institutions referred to in subsections (i) through (vii) of paragraph 3(b). CPME will also coordinate the entire program and liaise with the Bank in connection with contract performance. All activities relating to execution of the public services reform program under SHCP responsibility will be transmitted to the Bank through CPME.

#### Supervision

- 3.8 The IDB's Country Office in Tegucigalpa, with support from the program team, will supervise the progress of implementation of the reform program and this technical cooperation.

#### Consulting services

- 3.9 The services of consulting firms and individual consultants will be hired to carry out the proposed activities. Staff hired using the technical cooperation funds is to be incremental. The consulting services charged to technical cooperation resources will be hired following the Bank's standard procedures.

#### Equipment procurement

- 3.10 The Bank's standard procedures will be observed for acquisition of equipment to be charged to the Bank's contribution.
- 3.11 For equipment procurement, the CPME must submit to the Bank for its approval, through UNDP, a detailed list of equipment, indicating the respective prices, suppliers, and countries of origin. All purchasing or contracting orders between the US\$10,000 and US\$350,000 equivalent will be submitted with a minimum of three supplier bids. Acquisitions exceeding the equivalent of US\$350,000 shall be subject to the Bank's procedures.

- 3.12 Installation of equipment will require the availability of appropriate physical space. Therefore, prior to procurement of the equipment, the CPME must demonstrate to the Bank that it has sufficient space to install it.

#### IV. FINANCING

- 4.1 The total cost of the technical cooperation program is US\$16.7 million, of which the Bank's contribution, provided on a reimbursable basis, is the equivalent of US\$5.0 million to be charged to FSO funds. The IDA's contribution, also reimbursable, is US\$9.6 million, and the contribution of the Government of Honduras is the equivalent of US\$2.1 million. Table 3.1 below presents a summary budget, and Table 3.2 presents a summary by expenditure item.
- 4.2 Local counterpart funds will be aimed principally at financing the counterpart personnel of each component, national counterpart and support personnel for the coordination and modernization units, sales and/or import taxes, office space, office furniture and equipment, communications, and the operation and maintenance of the offices and equipment.

Table 3.1  
Summary Budget  
(in US\$000s equivalent)

Component	Technical cooperation		Local counterpart	TOTAL
	IDB	IDA		
1. Reform of public services	1,105.4	2,300.0	400.0	3,805.4
2. Institutional restructuring	1,322.2	259.6	241.0	1,822.8
3. Human resources management	1,255.8	1,033.2	320.0	2,609.0
4. Integrated financial management	408.0	3,513.4	570.0	4,491.4
5. Procurement and contracting	50.0	372.2	50.0	472.2
6. IHSS and social security	0.0	1,119.0	157.0	1,276.0
7. Environmental strengthening	166.8	0.0	155.0	321.8
8. Coordination and monitoring	484.0	686.1	157.0	1,327.1
SUBTOTAL	4,792.2	9,283.5	2,050.0	16,125.7
98. Contingencies	158.3	316.5	0.0	474.8
87. Finance charges:				
87.1 Inspection and supervision (1%)	49.5	0.0	0.0	49.5
87.3 Credit fee (0.5%)	0.0	0.0	25.0	25.0
TOTAL	5,000.0	9,600.0	2,075.0	16,675.0



Table 3.2  
Summary by Expenditure Item

Budget item	Technical cooperation		Local counterpart funding	Total
	IDA	IDA		
1.0 Consulting firms	771.0	3,481.0	0.0	4,252.0
2.1 International consultants	1,190.3	1,032.7	0.0	2,223.0
2.2 National consultants	1,377.9	1,412.1	55.0	2,845.0
3.0 Training	510.0	612.7	15.0	1,137.7
6.3 Equipment	943.0	2,208.0	35.0	3,186.0
6.0 General support	0.0	0.0	1,945.0	1,945.0
PFM-IDA financing	0.0	537.0	0.0	537.0
Subtotal	4,792.2	9,283.5	2,050.0	16,125.7
98. Contingencies	158.3	316.5	0.0	474.8
87. Finance charges				
87.1 Inspection and supervision	49.5	0.0	0.0	49.5
87.2 Credit fee	0.0	0.0	25.0	25.0
Total	5,000.0	9,600.0	2,075.0	16,675.0

## V. TIME PERIODS AND DISBURSEMENTS

### A. Time periods

- 5.1 The total execution period for the technical cooperation proposed in this document will be 45 months from the date of fulfillment of the conditions precedent. The deadline for hiring the head of the PCU, the monitor and the heads of modernization units will be three months from the date of signature of the agreement. The disbursement period will be 48 months from the date of fulfillment of the conditions precedent.

### B. Disbursement procedures

- 5.2 The following is the procedure for drawing down on the technical cooperation funding:
1. A breakdown of expenditure under each of the project components will be prepared by the CPME and submitted by the government;
  2. Once eligibility for disbursement of the technical cooperation funding has been declared, the executing agencies will contract for the goods and services in accordance with the financing Bank's rules and procedures;

3. An advance of up to 10 percent of the Banks' financing may be made. This amount will be replenished at the government's direct request, accompanied by a breakdown of expenditure on equipment and services previously approved by the Banks and must be justified within 120 days after disbursement of the advance.
4. At the government's request, direct disbursements may be made to suppliers in accordance with the Bank's procedures.
5. At the government's request, reimbursements of payments made may be made in accordance with the Bank's procedures.

C. Contractual conditions

1. Conditions precedent to first disbursement
- 5.3 The conditions precedent to the first disbursement of this technical cooperation's resources are as follows:
- a. have formally established and placed in operation the PCU in CPME, as well as the modernization units in SEP, SSP, SRN, SECOPT, SHCP AND SEC, and have equipped them with the staff and logistical support needed for their operations;
  - b. have hired (i) the chief, monitor, financial and accounting manager and consultant for the PCU institutional reform component; and (ii) the chiefs of the modernization units in accordance with Annex C to the contract;
  - c. have presented: (i) the strategic plan for the procurement of computer systems for the program; and (ii) basic programs for implementing the program by component;
  - d. have placed in effect procedures for coordination with the other institutions referred to in the third preambular paragraph to the contract.

VI. BENEFITS AND RISKS

- 6.1 This technical cooperation funding will strengthen the Presidential Commission on Modernization of the State and the ministries and executing agencies included in the program, contributing to timely execution technically supported by decision-making and the preparation of supporting documents for compliance with the conditions set out in the policy matrix of the reform program and the preparation of the activities of the State modernization program.

- 6.2 The risks that could arise in achieving this technical cooperation's objectives relate to the reform program which it seeks to support, the most important being difficulties which could arise in coordination and monitoring. Due to the complexity of execution of the program, a coordinating unit will be created within the CPME, strengthening will be provided to CCP in SHCP, and temporary modernization units will be formed in the agencies assigned reform priority. Also, execution of the program and the technical cooperation will be monitored by a full-time international consultant working for short periods adding up to one year and located in Honduras.
- 6.3 The second risk is the foreseeable lack of skilled personnel to carry out the reforms. This risk is mitigated by the strengthening of the coordinating and modernization units with technical teams of national and international consultants by area of specialization and with training programs within the components.
- 6.4 The approach of the technical cooperation's operation was limited to the areas covered by the reform program and to those with greatest impact on modernization of the State. It is hoped that this approach will increase the possibility of sustainability.

## VII. REPORTS

- 7.1 The CPME, as program coordinator, is to submit the following reports for Bank approval, prepared by the head of the PCU and reviewed and approved by the CPME:
- a. Within 30 days after the date on which the head of the PCU is hired, an initial report which will include:
    - (i) The general work plan and the schedule of execution indicating, by calendar quarters, quantitative goals for each activity or area of action as well as the appropriate indicators for achievement of these goals and the final objectives set for each activity or area to be ascertained and evaluated;
    - (ii) the persons involved in the program (coordinator, national and international consultants, technical team);
    - (iii) the schedule of activities for the first quarter.
  - b. Quarterly progress reports on the program, within 15 days after the end of each quarter, beginning with the first quarter after the head of the PCU is hired. These reports will contain a

detailed description of the activities carried out during the period in question and their status in relation to the schedule specified, the work to be carried out in the following period, and recommendations for solving any problems arising during execution of the program.

- c. Within 60 days after the end of the program execution period, or of such extension as both parties may have agreed, a final report containing a summary of the activities carried out and the results obtained in the program, the usefulness of the indicators used in monitoring the operation, and the impact on beneficiaries. The reasons for not achieving any of the planned goals or objectives, if this is the case, are to be indicated.
  - d. Any other report which the Banks may reasonably request.
- 7.2 SHCP will be responsible for remitting to CPME, for presentation to the Bank for approval, the reports on the component under its responsibility.
- 7.3 The consultants financed with Bank funds, whether on a short-term or long-term basis, are to present a final report upon completion of their visit, describing their accomplishments, additional activities required, and recommendations.
- 7.4 The CPME will submit to the Bank annual financial statements and a final financial report on program expenditure charged to the financing and the local contribution. These financial statements are to be audited by an independent firm of public accountants acceptable to the Bank, in accordance with standards satisfactory to the Bank.

PROPOSED RESOLUTION

HONDURAS. LOAN \_\_\_\_/SF-HO TO THE REPUBLICA DE HONDURAS  
(Public Sector 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 República de Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a Public Sector Reform Program. Such financing will be for the amount of up to US\$155,000,000 or its equivalent in other currencies, except that of Honduras, which are part of the resources of the Bank's Fund for Special Operations, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.

PROPOSED RESOLUTION

HONDURAS. TECHNICAL COOPERATION LOAN TO THE REPUBLICA  
DE HONDURAS FOR A PUBLIC SECTOR REFORM PROGRAM

The Board of Executive Directors

RESOLVES:

1. 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 agreements as may be necessary and to adopt such measures as may be pertinent for the execution of the plan of operations referred to in Document PR-\_\_\_\_\_ which comprises the proposal for a loan and a technical cooperation loan with the República de Honduras for the financing of a Public Sector Reform Program.
2. That up to the sum of US\$5,000,000, or its equivalent, is authorized for the purposes of this resolution, chargeable to the Bank's Fund for Special Operations.
3. That the above-mentioned sum is to be provided on a reimbursable basis, according to the terms and conditions set forth in the agreement to be entered into for this operation (hereinafter the "Technical Cooperation Loan Agreement").
4. That the Technical Cooperation Loan Agreement shall be signed simultaneously with the Loan Contract \_\_\_\_/SF-H0.