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PROJECT PERFORMANCE ASSESSMENT REPORT

HONDURAS

**PUBLIC SECTOR MODERNIZATION STRUCTURAL ADJUSTMENT CREDIT
(CREDIT NO. 2816)**

**PUBLIC SECTOR MODERNIZATION TECHNICAL ASSISTANCE CREDIT
(CREDIT NO. 2814)**

August 28, 2006

*Country Evaluation and Regional Relations
Independent Evaluation Group*

Currency Equivalents (annual averages)

Currency Unit = Lempira (L)

1998	US\$1.00	L13.39
1999	US\$1.00	L14.21
2000	US\$1.00	L14.84
2001	US\$1.00	L15.47
2002	US\$1.00	L16.43
2003	US\$1.00	L17.35
2004	US\$1.00	L18.21
2005	US\$1.00	L18.80

Abbreviations and Acronyms

ICR	Implementation Completion Report
IDA	International Development Association
IDB	Inter-American Development Bank
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IMF	International Monetary Fund
CGE	General Electricity Commission
CPME	Comisión Presidencial de Modernización del Estado (Presidential Commission for the Modernization of the State)
ENEE	Empresa Nacional de Energía Eléctrica (National Electric Energy Enterprise)
ENP	National Ports Enterprise
GDP	Gross Domestic Product
HIPC	Highly-Indebted Poor Country
PPAR	Project Performance Assessment Report
PSMP	Public Sector Modernization Program
PSMSAC	Public Sector Modernization Structural Adjustment Credit
PSMTAC	Public Sector Modernization Technical Assistance Credit
SAC	Structural Adjustment Credit
SEFIN	Secretariat of Finance
SIAFI	Integrated Financial Management System

Fiscal Year

Government: January 1 to December 31

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IEGWB Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Independent Evaluation Group assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEGWB annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by IEGWB. To prepare PPARs, IEGWB staff examine project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader IEGWB studies.

Each PPAR is subject to a peer review process and IEGWB management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the IEGWB Rating System

The time-tested evaluation methods used by IEGWB are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEGWB evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the IEGWB website: <http://worldbank.org/oed/eta-mainpage.html>).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings:* High, Substantial, Modest, Negligible.

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

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Principal Ratings

Public Sector Modernization Structural Adjustment Credit (Credit 2816)

	<i>ICR Review*</i>	<i>PPAR</i>
Outcome	Moderately Unsatisfactory	Unsatisfactory
Sustainability	Likely	Unlikely
Institutional Development Impact	Substantial	Modest
Bank Performance	Satisfactory	Moderately Satisfactory
Borrower Performance	Unsatisfactory	Unsatisfactory

Public Sector Modernization Technical Assistance Credit (Credit 2814)

	<i>ICR Review*</i>	<i>PPAR</i>
Outcome	Moderately Satisfactory	Unsatisfactory
Sustainability	Likely	Unlikely
Institutional Development Impact	Substantial	Modest
Bank Performance	Satisfactory	Moderately Satisfactory
Borrower Performance	Satisfactory	Unsatisfactory

* The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (IEG) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Public Sector Modernization Structural Adjustment Credit (Credit 2816)

<i>Project</i>	<i>Task Manager/Leader</i>	<i>Division Chief/ Sector Director</i>	<i>Country Director</i>
Appraisal	Antonio Martin Del Campo	Donna Dowsett-Coirolo	Edilberto L. Segura
Completion	Miguel Mercado-Diaz	Ernesto May	Donna Dowsett-Coirolo

Public Sector Modernization Technical Assistance Credit (Credit 2814)

<i>Project</i>	<i>Task Manager/Leader</i>	<i>Division Chief/ Sector Director</i>	<i>Country Director</i>
Appraisal	Antonio Martin Del Campo	Donna Dowsett-Coirolo	Edilberto L. Segura
Completion	Miguel Mercado-Diaz	Ernesto May	Donna Dowsett-Coirolo

Preface

This is the Project Performance Assessment Report (PPAR) of the Public Sector Modernization Structural Adjustment Credit (PSMSAC-C2816) and the associated Public Sector Modernization Technical Assistance Credit (PSMTAC-C2814). These credits were approved by the Board on February 8, 1996. The PPAR has been prepared based on the credits' documentation, including their implementation completion reviews, on interviews conducted in Honduras by an Independent Evaluation Group (IEG) mission and on interviews with International Development Association (IDA) staff.

The PSMSAC provided SDR 36.6 million, equivalent to \$55.0 million; it was supplemented by IDA reflows on four different occasions for a total equivalent to \$67.9 million. The Inter-American Development Bank (IDB) provided \$155 million in co-financing. The complementary PSMTAC provided SDR 6.4 million, equivalent to \$9.6 million, also co-financed by the IDB with \$5 million. The PSMTAC was closed on June 30, 2000 and the PSMSAC on November 30, 2001.

The assessment of the two credits has been combined in one single document because the two credits supported the same set of reforms (subsequently called the Project) and cannot be understood without reference to each other. However, the identity of the two credits is maintained throughout the report because they played different functions.

The review focuses on three major features of the operations: relevance and design, efficacy and efficiency, and sustainability. Since public sector modernization is a long-term endeavor, this report takes a long-term perspective, discussing the events that took place before the credits were approved, during their life and afterwards, up to mid-2005, aiming at identifying the contributions of the operations to what already was an ongoing process of modernization at the time of their approval. This approach is also useful for the assessment of the sustainability of the reforms.

The report is organized in seven sections and one annex. The first section describes the background of the operations, including the events taking place in Honduras and the objectives of the country assistance strategy (CAS). The second section summarizes the objectives of the public sector modernization program that the credits supported and the conditionality established for them. The third and fourth sections analyze the implementation of the PSMTAC and PSMSAC, respectively. Section five discusses the main issues raised by the two credits. Section six rates the operations and section seven draws lessons. The annex displays the disbursement conditions of the PSMSAC together with the ratings assigned to their accomplishment or failure by the credit's ICR and with IEG comments on the attainment of the credit's objectives in each of its components.

Following standard IEG procedures, copies of the draft PPAR were sent to the co-financier and government officials and agencies for their review and comments. No comments were received.

This report was prepared by Manuel Hinds (Consultant) under the supervision of René Vandendries (Task Manager/Consultant). Ms. Agnes Santos provided administrative support.

Summary

1. This is the Project Performance Assessment Report for two interrelated credits to Honduras: a Public Sector Modernization Structural Adjustment Credit (PSMSAC – C2816) and an associated Public Sector Modernization Technical Assistance Credit (PSMTAC – C2814). The ultimate objective of the two operations (the Project) was to help Honduras improve the efficiency of the provision of public goods and services as a means to stabilize the economy in a sustainable way. The PSMTAC supported the technical expenditures necessary to plan and implement the reforms while the PSMSAC provided balance of payments support while the reforms were carried out. The PSMTAC disbursed through a revolving fund in accordance with the needs of the technical work. The PSMSAC disbursed in three tranches against two kinds of conditions: (a) policy performance satisfactory to IDA/IDB (measured against targets specified in the letter of development policy); and (b) specific results attained in the reforms. In this way, the success of the PSMTAC was one of the preconditions of the success of the PSMSAC; the other one was satisfactory macroeconomic performance.
2. The specific objectives of the Project were to: (a) improve public service through greater private sector participation; (b) curtail expenditures by restructuring public institutions and employment; and (c) improve public management to enhance efficiency, transparency and accountability. Telecommunications, electricity, and airports were the sectors targeted for privatization.
3. The credits were highly relevant. They addressed urgent issues in public sector management and the link between those issues and the sustainability of macro stability was strong and clear. Moreover, the government appeared fully committed, having carried out several prior actions in preparation of the project. At the same time there were some important design flaws and the natural disaster of Hurricane Mitch in 1998 dramatically altered the government's development priorities. One of the design flaws was that the credits gave insufficient attention to the nature of the necessary market framework that would have to be introduced in the privatization area. The other was a strong reliance on inputs rather than outcomes in the conditions of disbursement, which meant that the credits could be disbursed even if the fundamental objectives were not met.
4. Achievements in terms of greater private sector participation in the provision of quality and cost-effective services were not as successful as originally anticipated. Of the three sectors marked for this purpose in the Project only airports were privatized, the first such effort in Central America. The concession granted with the support of the credits, however, had to be cancelled and another one established: the difficulties encountered in airports delayed the subsequent privatization of ports. Privatization and the breaking up of the government monopolies in telecommunications and electricity both remain problematic, although the 1995 Telecommunications Law, which was a precondition of the PSMSAC, opened the door for the introduction of competition and lowering of rates. Today Honduras has more cellular phone lines than fixed lines, and there has been an increase in private power generation; but many of the monopolistic controls by the

government remain. In terms of the power company, service did not improve much and neither did the company's financial position.

5. The administrative reforms fell short of expectations, but efficiency gains were seen from reducing employment redundancies. However, there was no reform of social security, the premature elimination of the Secretariat of Planning created new problems of coordination, and the rationalization of employment and salaries failed to resolve the most difficult problem in this area—the diverse treatment given to different groups inside the civil administration, which, in the case of teachers and physicians results in distortions that threaten the future macroeconomic stability of the country.

6. Public sector management reforms were positive, but limited. The decentralization of procurement and the establishment of a database for investment planning were accomplished as planned. On the other hand, the information system still relies on censuses in some cases to ascertain the number of employees in the public sector. The financial information system, developed under the credits, while contributing to a valuable learning experience, became unwieldy and was substituted by a new one.

7. Regarding the particular PSMSAC part of the Project, the macro performance was satisfactory on the whole and, because disbursement conditions were set in terms of reform inputs, rather than outcomes, these conditions were also mostly met, even if the objectives of the credits were not met. In the end, while the PSMSAC did not fully attain its intended objective, which was to provide balance of payments support for reform, the disbursements were useful nevertheless because they provided funds following the devastation caused by Hurricane Mitch in 1998, which completely altered the country context, development priorities, and IDA's short-term strategy.

8. The outcome of both credits is rated unsatisfactory. Reforms were positive, but limited, and due to the pressing needs in the aftermath of Hurricane Mitch much disbursement took place for reasons unrelated to the Project's original intentions. The sustainability of the reforms intended by these operations is rated as unlikely. While there has been limited reform and the pressing needs for reconstruction after Hurricane Mitch have subsided, many of the same problems that confronted the country at the time of the approval of the operations remain challenges today. These difficulties will eventually need to be overcome to make further and sustainable public sector reform.

9. Four major lessons emerge from this evaluation.

- In retrospect, this wide-ranging and multi-tranche operation that was typical of development lending operations at the time was too ambitious given the institutional framework of the country. IDA has largely learned from these lessons and moved away from this type of lending in favor of more modest single-tranche programmatic lending.
- While government ownership was solid at the outset, IDA did not adequately ascertain the strength of the many competing interest groups opposed to the operation. Assessing the broader political context for reform is important in assessing its likely implementation and sustainability.

- The market framework and strategy for reform in the energy sector should not focus solely on privatization and competition. While this model has worked well in many countries, the size and institutional features of the market may necessitate an interim strategy of partial privatization and regulation.
- The disbursement of final tranches in structural adjustment operations should be tied to the desired outcomes, not inputs, and IDA should avoid granting waivers connected to these outcomes. This lesson also applies to one-tranche programmatic operations, which also should focus on outcomes, not inputs.

Vinod Thomas
Director-General
Evaluation

1. Background

The Macroeconomic Situation

1.1 The recent economic history of Honduras, one of the poorest countries in Latin America, can be split in three periods. During the first period, from the early 1950s to the late 1970s, the main economic activities comprised commodities production and exports as well as an incipient industrial sector, which developed under the protection of the Central American Common Market. Price controls were pervasive and the government intervened heavily in the economy. The country enjoyed relatively high rates of economic growth and stable macroeconomic conditions during this period. Growth was particularly strong in the 1970s, propelled by the commodities boom of those years. The second period started in 1980 with the end of the boom, which was followed by a long-term decline in the real prices of commodities that has lasted up to the present. During this period, which went from the early 1980s to the early 1990s, the government tried to compensate for the decline in the country's terms of trade with expansionary fiscal and monetary policies. The result was that, while the economy stagnated, the rate of inflation and the deficit in the current account of the balance of payments ballooned to unprecedented levels. So did the external debt, which eventually would lead the country to qualify for the highly-indebted poor country (HIPC) program.

1.2 The third period started when the situation became unsustainable in the early 1990s and it became clear that drastic reforms were required. While the efficiency of the economy definitely improved during this period—as a result of the process of liberalization initiated in the 1990s the country's industry is now competitive—growth remained flat for most of the period and macroeconomic stability was precarious. The stability gained through strenuous efforts in one period was lost to subsequent expenditure sprees, particularly in pre-election years. Still, despite the tremendous economic loss due to Hurricane Mitch, the 10-year average fiscal deficit declined from 6.8 percent in the 1990s to 3.9 percent in the last ten years. This was the period that spanned the preparation, effectiveness, and closing of the loans.

1.3 The process of reforms started in 1990, when the Callejas administration launched a program of stabilization and structural adjustment, which included trade and price liberalization, the reduction of fiscal imbalances, and measures aimed at increasing the private sector participation in the economy. The specific measures of the program, supported by a 1990 International Monetary Fund (IMF) stand-by agreement, included tax reform and tax rate increases, adjustments to public utility rates, liberalization of the exchange rate, liberalization of interest rates, compression of import tariffs, elimination of non-tariff barriers, and cuts in public expenditures. The measures were successful. The rate of growth of the economy increased from zero in 1990 to 3.3 percent in 1991 and 5.6 percent in 1992 while inflation dropped from 34 percent in 1991 to 8.8 percent in 1992. This happened as the fiscal deficit declined from 6.0 percent to 4.8 percent in those years.

1.4 Simultaneously, the government identified the weakness that pervaded the public sector as one of the main obstacles to sustainable stabilization and, with the support of

IDA, the IMF and the IDB launched a Public Sector Modernization Program (PSMP), aimed at reducing the size of the public sector, improving managerial efficiency and increasing the participation of the private sector in the provision of public goods. It also created the Secretariat of the Presidential Commission for the Modernization of the State (CPME) to design, coordinate, and monitor the execution of reforms.

1.5 The incipient fiscal discipline and the will for sustainable reform, however, were lost in 1993, a presidential electoral year. The deficit of the non-financial public sector more than doubled to 10.7 percent of gross domestic product (GDP). Inflation started a climbing path that would lead it to 29.7 percent in 1995 while the current account deficit began to widen to reach almost 10 percent of GDP in 1994. The already bad debt ratios became even worse. By 1994 the supply of public services was in disarray and there were electricity shortages.

1.6 The worsening situation prompted a second drive to reform. The Reyna administration began a new stabilization program in 1994. By 1995, it had reduced the fiscal deficit from 7.1 percent to 3.5 percent of GDP. The emphasis of the Enhanced Structural Adjustment Facility (ESAF) agreement with the IMF shifted to expenditure rationalization and the privatization of public services. This gave new life to the Public Sector Modernization Program. The credits under review were designed to support it. They were approved and became effective in 1996 and were closed, in 2000 for the PSMTAC and in 2001 for the PSMSAC.

1.7 The fiscal deficit would go through yet another cycle of decline and increase in the ensuing years—with the worsening of the deficit caused first by Hurricane Mitch and then by the 2001 elections. The need to comply with the HIPC conditions for the Completion Point, which was delayed from end-2002 to 2005, prompted a third stabilization effort. The fiscal deficit fell from 5.5 percent in 2002 to 4.1 percent of GDP in 2003. As commodity prices increased, growth accelerated to 4.5 percent in 2004 while inflation in early 2005 was a still high 9.5 percent. Honduras reached its HIPC completion point in April 2005.

1.8 The unsteadiness that marked the efforts to stabilize the economy ran parallel with the uneven political support that the government provided to public sector reform through the period, which, like the stabilization efforts, became stronger during crises and weaker when the situation improved. This unevenness was a major problem during the implementation of the credits.

The Government's Efforts to Improve the Efficiency of the Public Sector

1.9 The second wave of public sector reform started with the enactment of an impressive array of modernization legislation. In 1994 Congress passed the Law of Restructuring of Public Sector Revenue Mechanisms and Expenditure Reduction, which authorized several measures to curtail expenditures and raise tax revenues. The government also drafted laws aimed at creating competitive markets and increasing the participation of the private sector in telecommunications and electricity. Congress approved in late 1995 the Framework Law for the Telecommunications Sector, which would gradually eliminate the monopoly of Hondutel, the state-owned telecom company,

and allow for its privatization. In energy, Congress approved a Law of the Electricity Sub-sector, which allowed for private generation, mandated the privatization of distribution and kept transmission within the public sector. The Law also segregated policy making, ownership, and services. It transferred policy making from the National Electric Energy Enterprise (ENEE) to a newly created agency, the General Electricity Commission (CGE after its Spanish initials). At about the same time, the government presented to Congress a draft Civil Aviation Law and the Law for the Honduran Enterprise of Airports and Air Navigation Systems, which aimed at decentralizing airport enterprise management. Additionally, the government created the Consultative Commission for Privatization (CCP) to lead the privatizations.

1.10 The government also included administrative reform as part of the objectives of PSMP. It reorganized the structure of the Secretariats, eliminating some of their departments, and planned for a reduction of 5,300 permanent posts. Congress also authorized the decentralization of procurement and the government aimed at establishing a comprehensive system for human resources management and a system of integrated financial management for the government.

1.11 IDA designed the two operations assessed in this report to help the government in all these tasks. The PSMSAC also aimed at helping the country to overcome its macroeconomic constraints during the period of adjustment, which management estimated would last at least until 1997-98.

The Country Assistance Strategy

1.12 The strategy discussed by the Board in the early 1990s focused on three main objectives: poverty reduction, public sector reform, and sustainable management of natural resources. In addition to the macroeconomic problems caused by the institutional weaknesses of the government, the strategy mentioned the country's low institutional capacity to implement projects as a justification for the inclusion of public sector reform among the main objectives of the strategy. The low implementation capacity was attributed to weak management capacity, lengthy legal procedures, and high staff turnover.

1.13 In addition to the credits under review, IDA supported the PSMP with components aimed at improving public administration in several projects, including the energy, basic education, transport, agricultural, and environmental development sectors. The credits under review would be the centerpiece of all these efforts.

2. The Project Objectives, Design and Conditionality

The Objectives

2.1 The objectives of the PSMP, described in the letter of development policy attached to an internal World Bank document, were to: (a) improve public service through greater private sector participation; (b) curtail expenditures by restructuring public institutions and employment; and (c) improve public management to enhance efficiency, transparency, and accountability. Telecommunications, electricity, and airports were the sectors targeted for privatization. The letter linked these activities with sustainable macroeconomic stabilization, which provided the rationale for the PSMSAC.

2.2 The internal World Bank document on PSMSAC calculated that the administrative reforms already carried out had resulted in a reduction in central government expenditures of 1.1 percent of GDP in 1994. Over the longer term, the program, including privatization, would provide additional annual savings of 2.7 percent of GDP. The estimate did not include savings from the privatization of electricity distribution or gains in efficiency and expenditure control associated with decentralizing procurement and other management reforms. The program would also result in a net reduction in public debt by an estimated 6 percent and corresponding debt service by \$43.3 million a year (or 11 percent of current debt service).

2.3 The same document estimated that the required reforms would entail sizable transitional cash expenditures. These included severance payments for the reduction of the payroll by 5,300 posts; training costs for the displaced; and micro-enterprise credits for those of the latter who decided to establish their own companies.

2.4 The internal World Bank document on PSMSAC also estimated that without IDA support the country would suffer serious financial gaps. According to these estimates, the then proposed PSMSAC, plus tranche releases of two other credits, would cover a substantial part of these gaps in 1996. The 1997-98 gaps would require the continued approval of IDA reflows and at least one additional adjustment operation.

Identification and Preparation

2.5 The credits were prepared based on solid economic and sector work, taking into account the inputs of different Bank activities. IDA had been cooperating closely on the subject of public sector reform for several years before the credits were approved and helped the country meet the conditions of Board presentation. The conceptual basis for the operation was the study on public sector reform in the early 1990s. IDA was instrumental in the design of the work of the institutions that the government created to modernize the public sector including the CPME, its secretariat, and the Consultative Commission for Privatization (CCP). Additionally, IDA provided valuable inputs for the laws that Congress approved since the early 1990s to enable the government to carry out the necessary reforms.

2.6 Thus, even if the scope of the credits was quite wide and complex, the government had given clear signals of its commitment to advance in all the covered areas. From the perspective of those years, the credits would help in finalizing processes that were already advanced. The country's ownership of the Project seemed substantial and its linkage with the stabilization of the country was well established. Moreover, the Project was supported by the IMF and the IDB.

The Main Components

2.7 While the main components of the credits remained unchanged throughout their life, their design was flexible with regards to the main activities that were included within those components. Flexibility was manifested in two dimensions. First, some activities that were mentioned in an internal World Bank document were dropped during implementation, while others that were not mentioned were subsequently included. This was the case, for example, with the reform of the social security system. It was included in the internal World Bank document but it was dropped when it became clear that no progress would be attained in that area. Ports, which had not been mentioned in the internal World Bank document, were included later, although eventually it was also dropped. Second, leadership in the implementation of the specific reforms was split between IDA and IDB in a flexible way. The leadership of some sectors, like airports for example, was allocated to IDB throughout the exercise, while that of other sectors was transferred from one institution to the other during the life of the loans, in some cases totally, and in some cases for specific sub-activities. Technical studies were routinely assigned to IDA. Finally, when Hurricane Mitch struck in 1998, flexibility in the disbursements of the loan was granted to assist in the reconstruction and recovery efforts after the natural disaster.

The Private Provision of Public Services

2.8 This component was directly linked to sustainable stabilization. The cash operations of state-owned companies are part of the fiscal accounts: their cash outflows increase the deficit of the Non-financial Public Sector and their cash inflows reduce it. This causes three kinds of problems. First, it creates incentives for the government to create monopolies to ensure that the cash profits of the state-owned companies will be maximized. Second, it ties the investment activities of these companies to the vagaries of the fiscal situation because investing in a telephone exchange, for example, has the same fiscal effect as investing in building a public school or a road. Thus, investments in capital goods that could be financed privately compete with investments in purely public goods and are often sidelined during times of fiscal compression. Third, when state-owned enterprises make operational losses in spite of their monopolies, their cash losses become part of the operational deficit of the government. Of course, these fiscal effects also cause problems in the supply of the goods and services that the state-owned companies produce because the incentive for the government is not just to give them a monopoly but also to restrict their investment. Engaging the private sector in the provision of public services was supposed to resolve these problems.

2.9 There was another aspect to the efficient transfer of the provision of public services to private providers that the laws enacted by Congress before the approval of the credits had taken into account. Since monopoly powers may be equally harmful when exerted by public or private institutions, the telecommunications and electricity laws established the legal framework for the creation of competitive markets in these sectors. Without an appropriate legal framework and market structure, privatization may fail to resolve the problems it is supposed to resolve and may even generate additional rigidities. Yet, neither the internal World Bank documents nor the subsequent documentation of the Project highlighted this as a fundamental aspect of the modernization of the sectors. Emphasis was placed on privatization and the implementation review rated the performance of the credits on that dimension alone. As discussed in the section on the implementation of the PSMTAC, the introduction of private electricity generation in the absence of an appropriate market framework, carried out before the credits were approved, not only did not resolve the problems that privatization was supposed to address but also created additional ones. As a manifestation of the emphasis placed on privatization, the implementation reviews did not discuss this issue and did not mention those problems. The privatization of some parts of the telecommunications markets created similar problems that were not discussed in the implementation reviews, either. As discussed later in the sections on the implementation of the loans, this was an important weakness of the Project. The following paragraphs describe the situation of the three sectors that the Project targeted for privatization.

2.10 *Telecommunications.* In Honduras, the monopoly rents of Hondutel, the state-owned telecom company, traditionally resulted in net cash inflows while the cash situation of ENEE, the electricity monopoly, and the social security institution—the Honduran Institute of Social Security (IHSS), had been deteriorating steadily by the time of the credits' approval. In the case of Hondutel, however, state ownership imposed severe limitations on its investment capacity. As a result, there was underinvestment in the sector, and telephone services in the country were primitive, unreliable, and narrow in scope. The objective in this sector was to privatize Hondutel, which, in accordance with the 1995 Law, would be gradually losing its monopolistic powers over a period ending in 2005. At the end of the process, Honduras would have a competitive market in telecommunications and Hondutel would be wholly privatized.

2.11 *Electricity.* In the case of ENEE, the electricity monopoly, supply was more adequate but the company made increasingly high operational losses. As noted before, the 1994 Law allowed for private generation, mandated privatization in distribution and kept transmission within the public sector. It also allowed for competition in the first two activities. As in the case of telecommunications, however, the Project emphasized the privatization aspect.

2.12 *Airports.* Airports had long been neglected in Honduras. By the time the reforms started, the government had already transferred the administration of the country's four international airports to non-governmental organizations (NGOs) established in the municipalities where the airports operated. These NGOs were organized mainly around the local chambers of commerce. These arrangements, however, were not producing positive results and there were little funds available for investment. The government decided to offer the concession of the four airports to a single international operator.

Administrative Reforms and Institutional Restructuring

2.13 While institutional restructuring had a less direct relation to the macroeconomic imbalances of the country, this linkage was still quite important. In the case of social security, operational losses were combined with an inadequate supply of services.

2.14 The administrative problems that the credits aimed to resolve were linked to the macroeconomic imbalances mainly through the overstaffing that prevailed in the public sector at the time; duplication of functions; the inadequate structure of salaries which made it difficult to hire top professionals; and the lack of coordination between different parts of the government.

Public Sector Management Reforms

2.15 This component addressed the government's need to improve its information systems in order to improve its managerial efficiency.

Project Coordination

2.16 The PSMTAC also financed the establishment and operation of a Project Coordination Unit in the CPME, which would coordinate the support of IDA and IDB as well as the internal reform activities. The PSMTAC would also finance an information and consensus-building campaign.

Disbursements and Conditionality

2.17 The PSMSAC contemplated three tranches. Its disbursement conditions were of two kinds. The first kind related to the macroeconomic framework and consisted in the maintenance of policy performance satisfactory to IDA and the IDB, measured against targets specified in the letter of development policy. The second kind listed, for each tranche, a series of actions that should be accomplished in the area of modernization of the public sector. The detailed conditions are shown in Annex B to this report. PSMTAC disbursed against the needs of the technical work.

Hurricane Mitch and the HIPC

2.18 While the strategy that the two credits aimed at supporting was spelled out in the strategy in the early 1990s, the circumstances of the country changed significantly during the life of the credits, introducing new priorities. First, in 1998 the PSMSAC became one of the channels that IDA used to help Honduras to recover from the devastation of Hurricane Mitch that hit the country in that year. Second, while improving, the constraints imposed by the external debt problem on the country's capacity to grow were becoming more evident at the end of the 1990s. The HIPC program was launched in 1996 and Honduras became a part of it in 2000, at about the time of the closing of the operations. By that time, the country was increasingly dependent on concessional loans such as those provided by IDA, which included the PSMSAC. The two events substantially altered the country context and changed the relationship between the PSMSAC and the structural reforms it supported.

3. The Implementation and Outcomes of the PSMTAC

The Private Provision of Public Services

Telecommunications

3.1 The specific objective of this activity was the privatization of Hondutel, or at least a company formed by it, that would provide telecommunications services to at least the two most populated areas in the country—Tegucigalpa and San Pedro Sula. The basic legal framework to attain this objective was contained in the 1995 Framework Law for the Telecommunications Sector. This law eliminated the different areas of the monopoly of Hondutel over a period ending in 2005 and allowed for its privatization in the intervening years. The private buyer would inherit the diminishing monopolistic powers over the established period. While the legal framework was not complete, because the law lacked the norms that would regulate the markets as the monopolistic powers of Hondutel expired, the law was the start of the more competitive environment seen today.

3.2 The tasks that had to be accomplished to create an efficient private sector telecommunications industry were many. They included at least the following: (a) removing the cross-subsidization that existed from international to national communications; (b) reducing the overblown staff to the levels needed for an efficient operation; and (c) eliminating the heavy load of perks that had accumulated over the decades. Carrying out tasks (b) and (c) required firing the staff, paying all the due compensations, and then rehiring the needed personnel.

3.3 The elimination of the cross-subsidization was essential from two points of view: the long-term profitability of Hondutel and the efficiency of the provision of telecom services. The eventual end of the company's monopoly on international calls would lead to an immediate fall in the prices of those calls. For the company to survive, this would be accompanied by a substantial increase in the price of local calls. Since private operators shy away from the political problems entailed by such a rebalancing of tariffs, best practice dictates that such realignment should be made before offering the telecom company for sale. An internal World Bank document for the PSMSAC acknowledged that in order to attract private investment, the government will rebalance tariffs, by substantially increasing the price of local services to make up for lower international rates.

3.4 Tariff rebalancing was necessary from the point of view of the efficiency of the supply of telecom services. With the cross-subsidization in place, competition from private investors would concentrate on international calls exclusively, while private investment in the subsidized domestic services would not materialize.¹

3.5 The government, however, went into the full process of privatization and got to the point of offering the company for sale without fully carrying out these reforms. The regulations that would apply to the increasingly liberalized market were not issued, either,

¹ As part of the reforms in 1995 under the PSMSAC, the government prepared a tariff rebalancing plan and carried out part of it: rates for local calls were raised, though insufficiently so.

so that the sector kept on working based on the regulations of a previous law that granted monopoly powers to Hondutel.

3.6 With these problems in mind, the advice of the investment bank was that the reservation price should be around \$100 million, and that certainly it should not be higher than \$170 million. It also noted that the unresolved problems—overstaffing, the existence of the high perks, the lack of regulations on the way the market would work after the legal monopoly was abolished and the cross-subsidization—would reduce the number of interested investors and that, in any case, those investors who decided to participate would discount their present values from the price of the company. The government set a price at \$300 million. Only one international operator, Telmex, presented a bid for the company. The offer was \$100 million. The process was declared null and Hondutel was not privatized.

3.7 Thereafter, since no regulations existed regarding the elimination of the monopoly powers of Hondutel, this elimination proceeded in a way that did not actually remove these powers. The first private cellular operator had received its license in 1994, before the public sector modernization (PSM) credits. In 2002, a second cellular operator received its license. In the absence of regulations on the functioning of an open market, this was done by integrating them as sub-operators of Hondutel—they work under concessions of the latter. The same arrangement has been made for other private companies that had entered the market, such as Internet providers. Finally, much beyond the period covered by the PSM credits, in November 2004, the government issued a program called “telephones for all,” which allows Hondutel to sell franchises to private operators.

3.8 In spite of these efforts, competition remains weak in a market overwhelmingly dominated by Hondutel, directly and through the monopolistic prices it charges its competitors for the use of its networks. With the introduction of cellular phones and some rebalancing of tariffs there has been some improvement in the quality of telecom services and in the structure of tariffs, but results have fallen far short of expectations. Also, the ten-year long exclusionary period given to Hondutel (para. 3.1) and little reform during this time meant that competition only recently emerged, inflicting heavy interim costs on consumers.

3.9 One of the consequences of these events was that the separation of policy making, ownership, and delivery, which was one of the objectives of the reforms in this area, fell short, in practice even when the 1995 Law attempted to do so. Controlling all the aspects of the sector, Hondutel has remained the policy-making institution in the country.

3.10 Now that Hondutel’s *de jure* monopoly of international communications has ended (December 25, 2005) the issues associated with the survival of Hondutel—the overstaffing and the heavy perks burdened on it, the cross-subsidization and the lack of market regulation—are coming to the fore front again, ten years after work on privatization was started. IDA is currently cooperating in defining policy options to deal with these issues.

3.11 At the time of the IEG mission, the government was also working on the regulatory framework for the new market. However, the discussion of these regulations has been mixed with preoccupation about the survival of Hondutel.

Electricity

3.12 The credits under review began their life within a context created by an earlier Energy Sector Adjustment Credit. The outcomes of that credit included the 1994 Law of the Electricity Subsector, which allowed for competitive private generation, mandated the privatization of distribution in a competitive way, and kept the transmission within the public sector. The Law of the Electricity Subsector also separated policy making, ownership, and regulation. Policy making was transferred to the General Energy Commission (CGE). Thus, in principle, the legal framework permitted to carry out the required reforms, which included the opening of the market to competition and the privatization of generation and distribution. However, the regulations needed to apply the law, had not yet been drafted.

3.13 While the Project documents defined the objective of this component as increasing private participation in the provision of electricity, the focus was on privatizing the distribution through outsourcing contracts in at least the most populous areas in the country (Tegucigalpa and San Pedro Sula). This was the condition that PSMSAC established for the release of its third tranche in this regard.

3.14 The privatization of such distribution required as a first administrative step, splitting ENEE into virtual companies in generation, transmission, and distribution. The accounts of the company, which had been separated for a long time, had been consolidated into a single, undifferentiated company, under an IDB technical assistance program. This initial step, however, was never taken, so that the accounting structure of ENEE remains as an administrative obstacle for the privatization of the company or any of its parts. As in the case of telecom, the regulations needed to apply the 1994 Law had not been drafted. As it also was the case in telecom, they still did not exist by the summer of 2005.

3.15 Before the credits were approved, the CPME planned to hire the International Finance Corporation (IFC) to carry out all the activities leading to privatization, including splitting the accounts, preparing the company or parts of it for privatization, drafting the necessary regulations for the functioning of private providers, and selecting the investment bankers. CPME wanted ENEE to pay for the IFC contract. A difficulty arose that, because of its by-laws, IFC cannot participate in bidding processes, while Bank and Honduran rules require them. Congress rejected the proposal to hire IFC. This stalled the process for a while.

3.16 With the PSMTAC, CPME decided to concentrate its legal efforts not on writing the regulations for the 1994 Law but on drafting a new one. It hired new consultants for this purpose. By the time the loan was closed, nothing had happened in terms of preparing the regulations of the 1994 Law, replacing the latter with the new proposed law or even splitting the accounts of ENEE.

3.17 In 2002, after the credits had been closed and after five years in which external auditors refused to sign its financial reports, ENEE asked CPME for support to separate the accounts of generation, transmission, and distribution. IDA, which had ceded the leadership of the sector to IDB since the beginning of the process, pledged its support. CPME agreed to support the process, too, but with two conditions: the 1994 Law should be replaced with the draft it had prepared and a new process of privatization should be started. It also conditioned its support to the participation of IFC as the main consultant in charge of the whole process. ENEE raised objections about the draft law and pointed out that a similar effort had been rejected by Congress several years before. The process stalled again.

3.18 Finally, IDA hired a consultant to draft a third law, taking into consideration all the stakeholders. When the draft was finished, the President of ENEE, who was also a deputy in Congress, tested the waters among his legislative colleagues on behalf of the government and concluded that the new law would not be approved as long as it included privatizations. Based on his report, the government abandoned the idea of privatization. That was the end of the original objectives of the component.

3.19 These events, however, did not preclude an increase in private participation in the electricity sector. Such participation, however, took shape that did not necessarily advance the objectives of the Project and even worsened the burden imposed by ENEE on the fiscal deficit.

3.20 The internal World Bank documents of the credits mentioned as an achievement of the government prior to the credits' approval that private generation had been growing in the years prior to Board presentation. The structural adjustment credit (SAC) implementation review mentions the addition of private sector generation as one of the benefits of the process and points out that some progress had been made towards increasing competition, efficiency, coverage, and quality of services despite the unsuccessful attempt to complete the privatization process. Approximately 50 percent of power generation is already being provided by the private sector in 2001. This surpassed most countries in the region without taking into account a planned investment amounting to about 12 percent of GDP for a new plant that would generate about 600 MW, almost doubling the country's capacity. An additional 128 MW out of a total capacity of 800 MW have been installed using private capital since 1998.

3.21 However, the private participation in generation has not benefited the sector. The first contract for 80 MW was signed in 1994 by a consortium of Costa Rican and American entrepreneurs in the midst of electricity shortages. The base price was \$0.18/KWH, much higher than market prices. The price was adjustable for oil prices, the rates of inflation in Honduras and the United States, the rate of devaluation of the Lempira, and several other variables. Contrary to what could be expected, the contract contained provisions that increased the price if capacity utilization went above 55 percent. Also, the contract specified that ENEE would pay a fixed charge, which was sufficient to generate profits to the private contractors, even if it did not buy energy from the consortium. Installed capacity was 80 MW. Similar contracts were signed in 1995 and 1996 (the latter when the credits were already effective) for a total of 140 MW, now with domestic suppliers, at \$0.17 and \$0.10/KWH, respectively. Though lower than

those established in the first contract, these prices were still excessive. This was the state of affairs when the credits became effective.

3.22 In 2002, ENEE opened a bidding process for 410 MW. An American corporation, AES, participated and announced their offer publicly, saying that it would be around \$0.05/KWH. It won the bidding but it had to resign from the contract for internal financial problems. In the process, however, it had set the standard of what was a reasonable price. ENEE split the contract between the second and third bidders, which, knowing AES' price range in advance, had offered prices around \$0.05/KWH.

3.23 The operation of the new 410 MW allowed ENEE to stop buying energy from the first three providers. However, the fixed charges that it has to pay them are high and account for a good part of the operational losses of the enterprise, which will be in the order of L.1,000 million (or about \$50 million) in 2005. As of now, all of these contracts run through until 2016 and, unless they are renegotiated, so will the losses to ENEE. Thus, the net result of these events was that, even if the government avoided the initial investments needed to generate more electricity, these costs came back to it as operating losses in the electricity company, paid to the private sector for electricity not generated.

3.24 Given this state of affairs, ENEE lacks funds for investment and maintenance. For this reason, leakages now amount to 23 percent of the produced energy, therefore more generation is needed to compensate for the losses.

3.25 Private entrepreneurs then became interested in hydro-generation, taking advantage of a "pro-renewable resources" provision in the law, designed to counteract the hidden externalities and subsidies in conventional energy, and which makes ENEE dispatch first the electricity generated with renewable resources, regardless of its price.² The prices offered by these generators are also well above the market price. The result is that ENEE is making a loss of \$3.5 million this year in those purchases.³

3.26 One problem with these developments in the generation area was that IDA (and IDB) changed strategies over time about what was needed on the competition issue. IDA decided that a much more profound market-based reform was needed instead of the initial incremental reform strategy. This turned out to be the wrong approach for a small market, where the size limits the potential for competition. Furthermore the fundamental element of an efficient privatization of public services, namely, the introduction of regulations allowing appropriate rules of competition in those sectors where this is possible, was never addressed. The emphasis of the credits was on the privatization itself. This emphasis was evident in the condition for disbursement established in this area for the third tranche of PSMSAC: award at least one contract for private sector participation in the distribution of electric power in accordance with the study carried out by the second tranche.

² The universal rule is that dispatch goes from the cheapest to the most expensive.

³ Not all private generation has taken these forms. Using the provisions stated in the 1994 Law, some private entrepreneurs have established generating plants to supply their own industrial companies. This has allowed Honduras' free trade zone exporters in particular to shield themselves from power interruptions and ensure continuity of production.

3.27 Today ENEE's accounts have not been separated, it is making large losses, leakages are mounting, and a future crisis is possible. While the emphasis in the credits was on distribution in order to achieve the greatest efficiency gains, distribution remained in public hands and is still the main problem faced by the sector. The 1994 Law is still in force but the regulations have not been issued, so that the sector works with regulations written in 1963 for a completely different law, which granted monopoly powers to ENEE.

3.28 Changing the structure that has evolved around private participation in the provision of electricity has become even more difficult today than at the time of the enactment of the law. This is because the maintenance of the monopolistic system gained the support of vested private interests—the private operators that produce under contracts with ENEE that effectively guarantee their profitability.

3.29 According to the interviews carried out in the country for the preparation of this report, while CGE was duly created, the institution has been subject to strong political influences. In practice ENEE, having total control of the system, sets the policy to this day.

Airports

3.30 The PSMSAC implementation review identified the following as the main outcomes of this sub-component: (a) the preparation of rules and regulations of the Civil Aviation Law and the Law for the Honduran Enterprise of Airports and Air Navigation Services; (b) assistance in (i) the creation of an autonomous normative regulatory entity, (ii) the creation of the public enterprise to manage airports and operate auxiliary air navigation services, and (iii) the extension of concessions to private operators for operating airport services; (c) the preparation of norms for selection and recruitment of sector staff; and (d) the development and implementation of a training program for technical and administrative staff. These actions complemented the actual privatization of the airports. The extension of the legal concept of concession to airports was crucial in this process because the civil aviation laws did not provide a sufficient basis to privatize these activities and the government decided to do it through the general Law on Concessions. While IDA helped in the development of this and in the drafting of the mentioned regulations, IDB took the lead in the actual privatization process.

3.31 Three international consortia competed for the concession. Each of them included one operator of airports or systems of airports in San Francisco, Vancouver, and Spain. The one including the operator of the San Francisco Airport won the concession. The concession, the first such effort in Central America, was ratified by Congress in April 2000 and the new arrangement started to operate in October of that year. The implementation reviews of both credits list this as one of the accomplishments of the operation.

3.32 The concession, however, was beset with problems and conflicts from the very beginning. The contract called for an extension of the runway of the Tegucigalpa airport as well as the revamping of the terminal building and associated services. The private operator committed itself to carry out these investments. As a counterpart, the

government would provide the land necessary for the expansion and would move the people then living on that land—two expensive commitments that the country could not undertake. None of these actions were carried out and, except for very minor improvements in Tegucigalpa and the other airports, the country's airports remain as they had been before the concession. The lack of successful privatization in this sector has weakened the case for similar privatizations in the country.

3.33 Lately, the contract with the San Francisco operators was dissolved and the government is working with the operators of the Vancouver Airport to revamp the system.

Ports

3.34 The technical assistance credit (TAC) contained a component to help in the privatization of port activities. This component included assistance to (a) prepare a study that would evaluate different options of increasing private sector participation in ports operations and its impact on the National Ports Enterprise (ENP); (b) develop policies and define the participation of private operators in Puerto Cortes and other ports, (c) define the institutional role of the ENP; (d) provide advice on restructuring ENP; and (e) develop mechanisms for the participation of private operators. Given the experience with the airports to date, these proposals are being delayed, at least for the moment.

Administrative Reforms

Institutional Restructuring

3.35 According to an internal World Bank document, institutional restructuring would redefine the role of Government and improve its effectiveness and efficiency by: rationalizing its size, restructuring its organization, and establishing an adequate legal framework with the new General Law of Public Administration which had been submitted to the National Congress. Rationalization and restructuring would be achieved by: (a) eliminating obsolete activities and entities; (b) merging or recentralizing those that are duplicated; (c) transferring to the private sector those that can be better performed by it; (d) contracting out those that can be more cost effectively carried out by other agents; and (e) decentralizing some to the regional offices or local authorities.

3.36 The PSMTAC implementation review lists a series of activities carried out under this component. All of them are inputs to the process: payment of consulting services to help several government entities to formulate and implement their institutional restructuring plans. The following paragraphs discuss these reforms in more detail.

3.37 *Social security.* The credits aimed at helping the Social Security System in attaining several objectives, including rationalizing the actuarial situation of the system; separating the finances of the provisional and the medical sides; devising a long-term strategy for the Honduran Institute of Social Security (IHSS) to improve its services and its financial condition; and improving the financial information of the institution. The expected strategy would establish the guiding posts for the reform of the pension and health systems and the development of professional risk insurance. These issues were deemed crucial because the system was not solvent and would become illiquid in the long term.

3.38 The credit financed a study to identify several alternative reform strategies. Nonetheless, the issues and the required reforms are still pending.

3.39 The government passed a law allowing for the creation of private pension funds and their associated management companies (Managers of Pension Funds, AFPs after their Spanish initials). Three of these funds were created but the managing companies of two of them went out of business when their associated banks failed. By 2005, only one of these funds remained and it was very small.

3.40 *The elimination of the Secretariat of Planning.* The restructuring also called for the elimination of the central planning office (SEPLAN) and the transfer of responsibility for policy formulation, technical cooperation and investment policies to the presidency. The elimination of this agency may have been premature. Transferring planning responsibilities to the presidency has proved difficult to implement because of the number of institutions involved, as well as generally weak public sector management. Similarly, the line secretariats did not assume responsibility for planning and evaluation of their respective programs through their Planning and Evaluation Units (UPEGs) as was expected. As a result, the restructuring had the unintended effect of creating a vacuum in terms of planning and evaluation functions and may have hampered the government's ability to coordinate poverty-reduction actions across the different social areas. IDA's follow-up operation, the Economic and Financial Management Project (EFMTAC), is currently providing technical assistance to the UPEGs to strengthen their capacity to plan, prepare and evaluate investment projects and operational programs, and to formulate policies. Thus, while accomplished, the premature elimination of the Secretariat of Planning did not advance the ultimate objectives of this component and may have hindered them.

Rationalization of Employment and Salary Regimes

3.41 The analysis of the performance of the credit in personnel matters is somewhat confusing in the available documentation for the two credits. The rationalization of employment and salary regimes is listed under two different components—administrative reforms and public sector management reforms. Superficially, it would seem that administrative reforms included one-time actions aimed at redressing imbalances while public sector management actions included measures aimed at creating and maintaining a permanent system. However, as the discussion of these points will make clear, the two aspects of this reform are too intimately related to be considered apart at least in the case of salaries. The possibility of fusing the two activities was contemplated when drafting this report but then discarded to avoid inconsistencies with the credits' documents. Thus, there is some duplication in the discussion of these activities—in this and the sub-section on public sector management reform.

3.42 The Project contemplated the following actions in this area: (a) downsizing to eliminate redundant staff and increase the ratio of professional and technical to support staff; (b) improving pay and grading structures of the Civil Service, particularly of senior level management and key positions, and developing a transparent pay structure for all civil servants; (c) establishing effective mechanisms for enforcing and monitoring controls of pay, employment levels and structures of the whole public sector; and

(d) developing a strategy to integrate the different employment regimes of the public sector with an aim to develop a comprehensive personnel policy. Staff performance would also be improved by creating long-term incentives through the introduction of career development streams and a new performance evaluation process.

3.43 *Rationalization of the employment regime.* The government had already made significant progress in reducing public employment by the time of the credit's approval. The Law of Restructuring mandated a 10 percent personnel cut in the civil service and decentralized institutions. Over 3,500 permanent posts had already been eliminated since January 1994. Moreover, other employment costs had been reduced, particularly in contract and daily workers. To comply with the 10 percent cut in permanent employment called for in the Law of Restructuring, it was envisaged that at least 5,300 additional posts would be reduced by April 1996 in the civil service and decentralized institutions.

3.44 The PSMSAC implementation review reports the accomplishments in this activity as well above the 10 percent required in the [government's] decree and the PSMSAC conditionality. From January 1994 to August 2001, the number of staff positions in the central government and decentralized institutions (excluding teachers, medical doctors, paramedics, police, and defense), was reduced from a combined 46,323 to 36,859, or an overall reduction of 20.4 percent. In fact, the Law of Restructuring did not exclude any group from the tally, so that the reduction in positions that took place under the life of the credit was about 5,500, almost exactly as it had been anticipated.

3.45 *Rationalization of the salary regimes.* The PSMTAC implementation review reports progress in this area under the heading of public sector management reform as having met the performance indicator for decompression in the PSMSAC action plan. As a result of the adjustment process, the compression ratio of civil service salaries has gone from about 6:1 in December 1998 to 10:1 in January 2001. Thus, the average base salaries rose sufficiently to regain the levels at the beginning of the decade in real terms. However, the fiscal impact of this reform was minimal although it made an important improvement in the salaries of mainly top technical and professional staff as the number of people involved was relatively small due to the existing bottom-heavy structure of the civil service.

3.46 These accomplishments, however, fell short of the objective of rationalizing the salary regimes. Those regimes remain split into several regimes established for different groups of public sector employees. These regimes include the military, teachers, physicians, and police, which make two-thirds of the public servants. The structure of salaries in each of these regimes remains quite different from each other, therefore the compensation for similar responsibilities diverges across groups. Moreover, the regimes established procedures to adjust salaries making sure that the differences will increase in the future. In fact, the main problem in this area is the regime, established after a pre-election negotiation, for teachers and physicians, which represent about 50 percent of public servants. The regime created a system of automatically increasing real salaries that would be unsustainable in the long term. According to government calculations, within a few decades the system would absorb the totality of the fiscal revenues of the country. The problem was so acute that the government was able to reach the HIPC

Completion Point only after negotiating with teachers and physicians a delay of the agreed benefits. The long-term problem, however, remains unresolved.

3.47 Partly because of these problems, the government issued an Executive Decree in April 2001 establishing a ceiling on salaries and mandating that, beginning in 2002, salary increases be based on performance evaluations. The PSMSAC rates the objectives in this area as accomplished based on this Decree.⁴ Yet, the Decree fell short of the objectives of the credits in this respect, which implied a thorough rationalization of the salary regimes. The idea of the reform was precisely to prevent actions such as the imposition of arbitrary ceilings.

3.48 *Actions in other areas of the government.* The government carried out a series of smaller tasks in several areas of the government. These are listed in the PSMSAC implementation review. They include reforms in the Secretariats of Public Education; Health; Communications, Public Works and Transportation; Natural Resources; and Economics and Finance. The credit also helped in the creation of the Honduran Institute for Children and Family, substituting the functions previously performed by the National Board of Social Services.

Public Management Reform

Development of a Comprehensive Public Sector Human Resources Management and Effective Control Mechanism

3.49 In this respect, the reform aimed at improving integrally the information systems that support public sector human resource management and control in a comprehensive fashion. The government had been developing and implementing a human resource and payroll database for the Civil Service and other central government regimes, which would be extended to the rest of the public sector. It had also been carrying out a census and audit of posts in health and planned to extend it to other sectors, particularly in education. The government had also formed, within the Presidential Commission for the Modernization of the State, an Inter-ministerial Commission for Employment and Salary Policy which would monitor and control employment indicators. The credit would support these efforts.⁵

3.50 The PSMTAC's implementation review lists a series of actions that were carried out under the human resources component as a whole. They included the creation of the comprehensive database, the classification of posts under four groups (administrative, technical, management and directors) and fifteen categories; and the implementation of a new salary structure, which was carried out by leveling salaries upward in several stages.

3.51 The same review indicated that the monitoring of employment has been satisfactory. An employment census has been carried out in the Secretariat of Health. It also carried out post audits aimed at verifying the accuracy of recorded positions in the

⁴ The implementation review rates the outcomes of the rationalization of employment and salaries together, classifying them as accomplished.

⁵ Letter of development policy, PSMSAC internal World Bank document.

Secretariats of Finance, Education, Agriculture, Natural Resources, Industry and Commerce, Interior and Justice, Cultural Affairs, and Labor. Although monitoring is still weak for the decentralized institutions, the government continues to improve the timeliness and completeness of the data. So far, no effective mechanism exists to transform the one-time checks into a permanent staff list. Once the system for human resources management is operational, a permanent system of staff audits should be in place and linked to that system.

3.52 Despite improvements, a comprehensive public sector human resources management and effective control mechanism is currently not in place. The government still has to rely on censuses to ascertain exactly how many employees it has in some sectors. This problem also reveals weakness in the effectiveness of the Integrated System of Financial Information of the Secretariat of Finance, discussed in a subsequent section. Tracking salary expenditures and savings is essential to ensure fiscal discipline.

3.53 Moreover, the draft law that the government presented to Congress to regulate the civil service in a comprehensive way has not been approved. Many deputies see it as unnecessary because the major groups in the civil service already have their own specific regimes. Many of them see the remaining positions as those that incoming regimes should be able to fill with their supporters after winning presidential elections.

Development of an Integrated Financial Management and Public Sector Programming

3.54 *The Information Systems of the Secretariat of Finance.* The preparation of the credits correctly identified the weak state of the information systems of the Secretariat of Finance (SEFIN) as a key problem that was essential to resolve. Each of the major departments in the Secretariat had its own information system and accounting definitions. This resulted in severe difficulties in the elaboration of budgets and slow and inconsistent financial reporting. To deal with this problem, the TAC included a component for the development of an Integrated System of Financial Administration (SIAFI) for its initials in Spanish. The idea was for the new system to be more than a computerization of the existing processes. It should introduce efficiency in the information processes and become a management tool.

3.55 The PSMTAC implementation review lists a series of benefits that were attained with the SIAFI. It describes that the system became operational for the preparation and execution of the budget in 1999. Thereafter, the implementation of the related computer systems in the central government began with the installation of SIAFI throughout five pilot secretariats (Finance, Health, Education, Government and Justice, and Industry and Commerce) where the system became operational. The implementation of SIAFI resulted in the decentralization of budget execution by 51 percent in terms of the number of transactions and 66 percent in terms of the amount of all the transactions done by the central administration. Similarly, it is estimated that the Health Secretariat was responsible for executing 72 percent of its budget during 1999 and 98 percent during the year 2000. The implementation review also mentions that after implementing SIAFI, the timetables for processing payments decreased considerably. For instance, the processing time of budgetary transactions in SEFIN went from an original 56 days to 6 days, while

the average procurement time in the Health Secretariat was reduced from three months to 15 days.

3.56 These were substantial achievements. The generalized perception in the Government of Honduras, however, is that the SIAFI was not adequate. The rationalization of processes and the distillation of the kind of information that was required for managerial decisions were carried out hurriedly. The emphasis was on the mechanization of the processes. The result was that computerization became increasingly awkward and voluminous, to the point of becoming unmanageable. As expressed in the implementation review, the Secretariat used some of the modules of the program in the elaboration and presentation of the budget in recent years, attaining some efficiency gains. Yet, continuous manual adjustments were required, so that the system became a discomfited hybrid. The attempts to extend the system to other dependencies of the government further complicated these problems.

3.57 After more than five years of unsuccessful trials, and a better knowledge of what is likely to work, the Secretariat decided to drop the entire system and start a new one. Through technical assistance associated with IDA's FY01 Economic and Financial Management Credit and the first Poverty Reduction Support Credit, a complete SIAFI redesign has now been completed, and is being rolled out within the Central Administration during FY06. A complementary IDB credit is supporting implementation of certain related business process changes within the Ministry of Finance. The process of elaboration of the new system started with a thorough review of processes aimed at rationalizing and simplifying them and with a clear determination of the information flows that were essential for management. The work started in January 2005. It has proceeded so fast that the 2006 budget will be elaborated with the new system. The officers in charge of the information systems and top officials in the Secretariat say that the mistakes of the "old SIAFI" helped them to focus on the points that the new process should address to make a success of the new one.

3.58 Part of the difference between the old and the new SIAFIs can be attributed to technological change. At the time the logic of networks had not been fully developed and Internet was rare in Honduras. The emphasis of the system was in establishing a close connection between server and users rather than interconnecting all users. The technological problems included the lack of efficient media to transfer the information within the city of Tegucigalpa. To resolve this problem, the credit financed a network of optical fiber linking the major users of the system in a pilot experiment. Now the situation has changed and Internet is available.

3.59 The main problems of the old SIAFI, however, were not with the hardware but with the approach to the software problem and its relationship with management practices. Discussing this point with the technicians in charge of the new SIAFI and top functionaries of the Secretariat they said that the approach taken by the old one was common practice at the time of the operation. The approach used in the new SIAFI emerged in the last few years, partly as a result of the weaknesses of the old one in Honduras and other countries. The consulting firm managing the new SIAFI competed for the contract for the old one with a proposal that was quite similar in approach to the

one that won. Other countries that tried to build systems similar to the old SIAFI encountered similar problems.

3.60 Thus, it seems that IDA did what was possible at the time, particularly in light of the comments of the government officials, which affirmed that in this and other areas IDA staff had been extremely cooperative, open to suggestions and quite professional. The priority given to mechanization over simplification and modernization of procedures was a weakness in design that was a common problem across countries, including Honduras.

3.61 *Public Investment Management.* The credit also supported SEFIN's efforts to improve the programming and management of public investment. The idea was to create a data base of ongoing and planned investments called the Integrated Public Investment System (SISPU). The system, however, was not created during the life of the operations reviewed in this report. It has been developed in the last few years with the support of a new operation, the Economic and Financial Management Project (EFMTAC) under the approach of the new SIAFI. Thus, while public investment management will be improved with Bank support, the actions taken for such improvement cannot be attributed to the evaluated operations.

Procurement

3.62 Before the credits, procurement was centralized in Honduras. The procurement process was highly inefficient and caused long delays in the activities of the executing units. The credit supported a plan to decentralize purchases. With the support of the credits, all operational functions were removed from the Central Procurement Office (CPO). The responsibility for procurement was transferred to the executing entities and the CPO was transformed into a small normative office. The existing Public Procurement Law was amended in September 2001 to provide a sound legal framework for new procurement procedures. As foreseen during the preparation of the credit, the new structure has improved the efficiency of procurement. The activity will be integrated with the SIAFI before the end of 2005.

Project Coordination

3.63 The PSMTAC also financed the establishment and operation of a Project Coordination Unit in the CPME.

Summary

3.64 In summary, the PSMTAC did not attain all that was expected for an efficient transfer of the provision of public services to the private sector in three dimensions. First, of the three sectors marked for this purpose, only airports were privatized. The concession granted with the support of the credit, however, had to be cancelled and another one established. The difficulties encountered with the airports concession stopped the privatization of ports.

3.65 In the case of telecommunications, while the 1995 Telecoms law had opened the door to the introduction of competition, the planned privatization failed at the last stage.

However, this failure was at least partly attributable to the poor preparation of Hondutel and the regulatory framework for the functioning of the company after privatization.

3.66 In the case of electricity, most of the private generation that emerged in the country, created before the credits, has not resolved the fiscal problems it was supposed to resolve. Moreover it has created other serious problems. The financial condition of ENEE remains weak. While the credit's objective to increase the private provision in the entire sector, the conditions of disbursement of PSMSAC (reviewed in the section IV) included only the privatization of distribution in at least the most populous areas in the country. Yet, the main administrative task that should have been carried out before proceeding to this limited privatization—the separation of the accounts of ENEE into virtual companies in generation, transmission and distribution—was not carried out.

3.67 The administrative reforms were positive, but fell short of expectations. Advances in social security have been marginal and the premature elimination of the Secretariat of Planning may have created new problems of coordination. The rationalization of employment and salaries made little progress in resolving one of the most difficult problems in this area—the diverse treatment given to different groups inside the civil administration, which, in the case of teachers and physicians, resulted in distortions that contributed to increasing fiscal imbalances.

3.68 The information system for human resource management still relies on censuses to ascertain the number of employees in parts of the public sector. The initial financial information system became untenable and, with the experience gained by the first attempt, was substituted by a new one. The decentralization of procurement and the establishment of a database for investment planning were successful tasks that were accomplished as planned in this component.

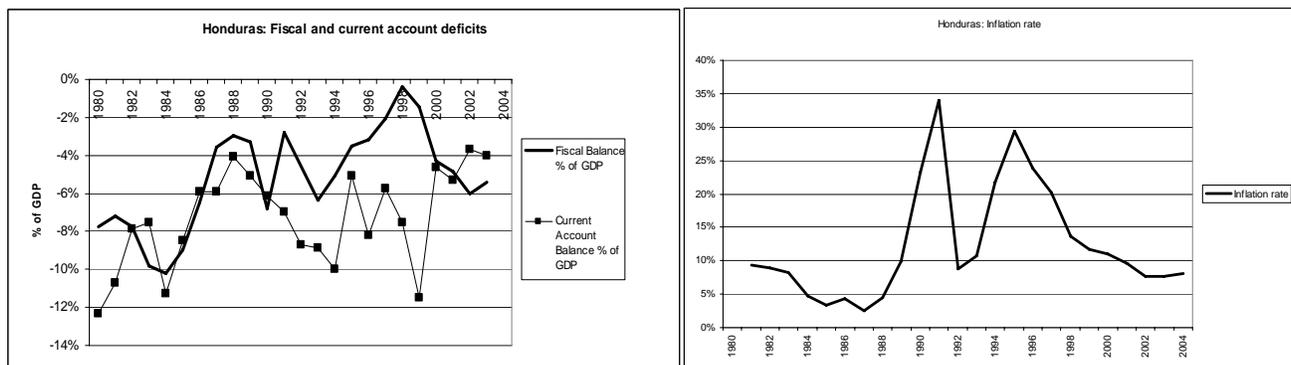
4. The Implementation and Outcomes of the PSMSAC

The Macroeconomic Outcomes

4.1 The letter of development policy set out the intentions of the government in this respect as: (a) spurring export-led growth of at least 4.5 percent per year; (b) reducing the fiscal deficits to 1.5 percent by 1997 and continue to enforce fiscal discipline in the following years through the modernization of the public sector and the privatization of public services; (c) managing monetary policy so as to reduce the rate of inflation to around 5 percent by 1997 from 12 percent in 1995. The letter also mentioned that the high external indebtedness of the country seriously impeded growth and threatened social welfare. Honduras became a HIPC country in 2000.

4.2 As shown in Figure 1, the fiscal performance of the country improved in the years immediately after 1996, so that by 1997 Honduras was roughly in compliance with the objectives set in the letter of development policy. Along with this improvement, the current account deficit in the balance of payments narrowed and the rate of inflation declined. However, both the fiscal and the current account balance deteriorated sharply in the aftermath of Hurricane Mitch in 1998. Subsequently, as had happened before, the fiscal deficit deteriorated further in the year leading to the presidential elections of 2001. Thus, by the 2001 closing of the credit the fiscal deficit was higher than, and the current account deficit almost as high as, their levels at the start of the Project.

Figure 1. Honduras: Macroeconomic Stability Indicators



Source: International Financial Statistics, IMF.

4.3 The resulting imbalances delayed the attainment of the agreement with the IMF that was necessary to reach the Completion Point in the HIPC process from an initial estimate of 2002 to April 2005. As shown in the second panel of the Figure 1, the inflation rate declined steadily through that period. Although its level in 2004 was still higher than the target for 1997, the trend was in the right direction.

4.4 The economy, however, has been unable to grow at rates fast enough to overcome the rate of growth of the population. It grew at 2.2 percent in real terms from 1995 to 1997, substantially less than the forecasted 4.5 percent. As shown in Figure 2, GDP per capita, as measured in constant 2000 dollars purchasing power parity (PPP) took a dip

right after Hurricane Mitch and, after recovering a little, remained virtually flat since 2000. This trend, however, seems to be changing. In 2004, GDP in constant local currency units increased by 4.5 percent and growth in 2005 is expected to be in the same order of magnitude.

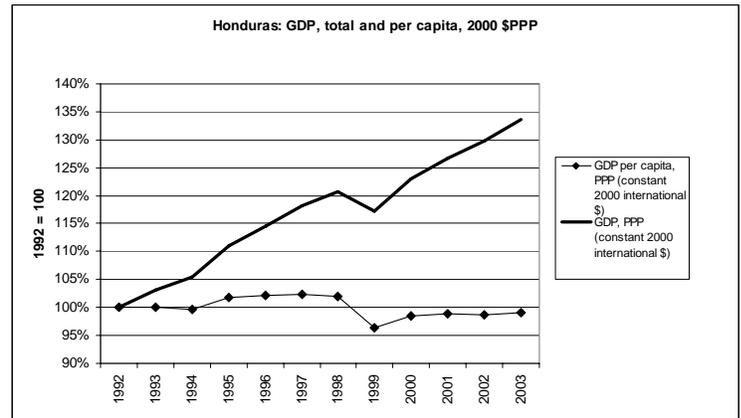
4.5 As shown in Figure 3, the country's debt indicators improved steadily since the mid-1990s. With debt to gross national income (GNI) and to exports at 83 percent and 158 percent, respectively, the burden of the debt is still heavy. As pointed out before, however, Honduras reached the Completion Point in the HIPC process in April 2005, which is expected to help it to further reduce these ratios in the future.⁶

Disbursements

4.6 Disbursements were carried out against approved general government expenditures. After the 1998 Hurricane Mitch they included substantial reconstruction expenses. They also included funds that the government used to confront the unexpected failure of one bank. Thus, in addition to providing the usual balance of payments help, the credit was useful to deal with emergencies.

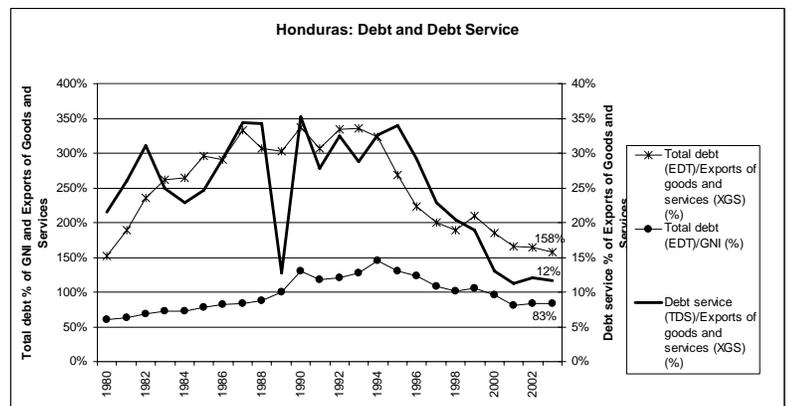
4.7 Disbursements of the PSMSAC would be triggered by compliance with several tranche conditions, which included policy performance satisfactory to IDA-IDB (measured against targets specified in the letter of development policy), as well as specific actions carried out in the implementation of the Public Sector Modernization Program. As discussed above, the macro performance was roughly satisfactory until 1997. Although it deteriorated after 1998, such deterioration could be

Figure 2. GDP and GDP per capita, 2000 \$ PPP



Source: World Development Indicators, World Bank.

Figure 3. Honduras: Debt and Debt Service, % of GNI and Exports



Source: Global Development Finance, World Bank

⁶ There is one dimension, however, in which the HIPC incentives will complicate macroeconomic management. As noted by some Honduran functionaries, injecting a substantial portion of the external debt service into the economy would lead to increased rates of inflation, larger current account deficits or both. To avoid this, the central bank would have to sterilize the injected resources. The net result would be that the central bank would gain international reserves while interest rates would increase, crowding out private investment.

partly attributable to the effects of Hurricane Mitch. Thus, it is understandable that IDA relaxed its macro standards in those years.

4.8 The structural conditions, however, present a curious situation. While, as shown in Annex B of this report, most of the disbursement conditions were complied with the objectives of the credit were not attained in most of its components and none in the fundamental ones. This situation arises in part because the disbursement conditions were set in terms of inputs to the process rather than in terms of its outcomes. The following paragraphs summarize the situation in each of the major activities, based on Annex B.

Private Participation in Public Services

4.9 *Telecommunications.* The government met four of the five conditions of disbursement and the fifth was waived. The one waived was the privatization of Hondutel, the main objective of the credit in this component.

4.10 *Electricity.* The government met two of the three conditions of disbursement. The one that was waived was the one that defined the objective of the component: having at least one distribution company privatized. Up to this moment, distribution companies do not exist, as the function is carried out by ENEE without differentiating it from generation and transmission.

4.11 *Airports.* The government met all the conditions of disbursement. Yet, the privatization was unsuccessful, partly because the contract assigned obligations to the government that it could not comply with.

Administrative Reform

4.12 *Rationalization of employment and salary regimes.* The government complied with the three conditions of disbursement. Yet, the employment and salary regimes remain inefficient because of the various treatments given to the different groups in the civil service. Moreover, some other crucial objectives in the area of administrative reform, such as the already mentioned reform of the social security system, were not included in the conditionality and were not accomplished at all.

Reforms of Public Management

4.13 *Human resource management system.* The government complied with the conditions of disbursement. Still, the system is not fully operational and the government still relies on censuses in some areas to ascertain the number of people it employs.

4.14 *Financial management and public investment programming.* The government complied with the four conditions of disbursement. However, the main component of this activity, the old SIAFI, was found to be inadequate and, with the experience gained, was replaced by a new design.

Summary

4.15 In summary the PSMSAC did not attain its full objective to support the country in implementing a wide range of public sector reforms. As discussed in this and the previous sections, the problem was that the reforms did not produce the expected results. Certainly, the PSMSAC was quite useful to transfer resources to the country in the immediate aftermath of Hurricane Mitch, but the hurricane had the effect of delaying the public sector reform progress. While progress has been made in some parts of the public sector, it has been incomplete in others. These results were due to a combination of several factors, including weak design in some cases, a lack of institutional support in others, and the dramatic economic loss due to Hurricane Mitch in 1998 that completely altered the development priorities of the country and donors.

5. The Main Issues

The Inconsistency between Compliance with Disbursement Conditions and the Attainment of Objectives in the Overall Operation

5.1 The main issue that arises in these credits is that while most of the conditions for disbursement were complied with, the important objectives were not achieved. This issue is clearly related to the design of the combined operation of the two credits, the best practice options available at the moment of such design, the external shock of Hurricane Mitch, and the political economy of the reform process.

5.2 Conditions of disbursement can be designed in two main ways. One is to link them to specific outcomes, such as the completion of the privatization of an institution. The other is to link them to the provision of the inputs necessary for that outcome, such as preparing studies and sending draft laws to Congress. The credits had conditions of both kinds, but most were related to inputs. This made it possible to meet the disbursement conditions without attaining the expected outcomes. The use of inputs in disbursement conditions is not bad in itself. It is the only way in which technical credits can be disbursed. However, the experience of this credit (as well as others in other regions) shows that in structural adjustment operations such conditions should be used for intermediate, not the final, tranches. Subsequent policies in lending operations, in Honduras and other countries, have now moved away from wide-reaching multi-tranche operations in favor of more modest single-tranche programmatic loans.

5.3 Supervision waived only two of the conditions out of the 28 that dealt with reforms in the PSMSAC.⁷ These two, however, related to important outcomes: (a) having transferred the management and control of the phone companies established by Hondutel to operate basic telephone services in Tegucigalpa and San Pedro Sula; and (b) having awarded at least one contract for private sector participation in the distribution of electric power in Tegucigalpa and San Pedro Sula. The project documents explained that the reason for waiving these conditions was that the funds provided by PSMSAC were urgently needed for reconstruction after Hurricane Mitch. Indeed, this was a priority, but the consequence was that these reforms were delayed.

The Undue Emphasis on Privatization over the Introduction of an Appropriate Competitive Framework and Regulation in Telecommunications and Electricity

5.4 As was discussed in previous sections, the emphasis was on privatization. The nature of the necessary market framework was given much less attention. In the privatization efforts in the area of power generation, for example, IDA promoted a profound market-based reform. This appears to have been the wrong approach: in small markets, such as Honduras, the difficulty in creating a competitive market is high, and, as is now generally recognized, intermediate and more modest objectives have a higher likelihood of success. Today, almost a decade after the initial process supported by the credit started, the regulations needed for the functioning of competitive markets are not yet adopted. The laws of telecommunications and electricity that were enacted in the early

⁷ Two more were waived but were consequently accomplished.

1990s are still applied within the regulatory framework of the old laws, which granted monopolies to the state-owned companies in those sectors.

The Uneven Ownership of the Projects Supported by the Loans

5.5 In retrospect, the design of the credits underestimated the political difficulties that passing reforms as deep as those that they promoted would entail. Taking this retrospective view, however, would not be fair, as the government had taken several actions before Board presentation that were thought to be enough to generate a political consensus for reform.

5.6 The IEG mission to Honduras found that there were two groups of people, distinguishable by their embrace of the objectives of the credits. There is a core of people who enthusiastically supported the objectives and thought that the credits gave the opportunity for real reform of the state. Many people in the current government take this view. The second group, which also includes people in the current and past governments, takes a different view.

5.7 People in the second category told the IEG mission that IDA tends to push self-generated agendas rather than focusing on the specific needs and circumstances of the borrowing country. Furthermore, they added that IDA's internal agendas tend to follow development "fashions." For example, they said, at the time of the approval of the credits under review the fashion was privatization. Today the subject has largely been dropped from the agenda. Honduras, they said, accepted this agenda but did not embrace it. They had to accept it because the SAC, which they needed for balance-of-payments reasons, linked its disbursements to these and other reforms. For these people, carrying out the reforms specified in the credit contract was the way to get access to the funds of the PSMSAC.

5.8 The credits supported the first group. The confrontation between the two groups was not limited to the debates in Congress. It is clear that the government's support for the reforms fluctuated during the life of the credits and even afterwards. Administrative delays such as those that eventually derailed the electricity reforms could have been handled in more effective ways. Some of the technocrats who worked on the implementation of the planned reforms complained that support from the political authorities was very weak and sometimes non-existent when they faced opposition to the reforms. For example, lobbying in Congress was left to the technocrats in most cases. In the end, the group that resisted the reforms proved more powerful.

Disbursement Problems

5.9 Honduran authorities pointed out a problem that they found during the implementation of the PSMTAC. This relates to the use of one single revolving fund for a credit with many executing agencies. They said that frequently the disbursements urgently needed by one of the agencies were blocked because of previous disbursements to other agencies. They believe that the ensuing delays caused severe problems during the execution of the credit.

6. The Ratings of the Operations

6.1 Public sector modernization is a long-term process that entails managing the changing views of many public servants and civil society, overcoming political obstacles, and carrying out complex tasks of coordination. It requires, in addition to clarity of purpose, a strong determination to meet such purpose. It requires persistence. In this sense, the continued efforts of IDA to modernize the Honduran public sector through these and other operations have been satisfactory. Defeated in many attempts, IDA has readjusted its strategy and tried again, sometimes attaining the desired objectives on the second or the third try. This is the case, for example, of the SIAFI, which failed in the first attempt but seems to be on its way to become a success in the second one. In other cases, like the privatization of ENEE, IDA has scaled down its objectives to what is politically possible—in this case, creating financial units corresponding to those that would become independent enterprises in case of privatization. In some other cases, reforms have been dropped from IDA activities when they have become unfeasible. This has all taken place within the context of the 1998 external shock of Hurricane Mitch, which dramatically changed the country context and altered the reform priorities of the government and donor agencies.

6.2 Thus, while the failures to attain the desired outcomes with these credits can be largely attributed to the government's uneven ownership of the Project, the risk that IDA took when embarking in this operation was reasonable and consistent with the only approach that is feasible in this politically difficult area. The conditions for Board presentation that the government met indicated that there was a level of commitment worth taking risks. Yet, while acknowledging the satisfactory persistence of IDA, it is clear that there were many weaknesses in the planning and implementation of the credits.

6.3 The criterion adopted for the ratings is that an activity is rated satisfactory or unsatisfactory in accordance with the degree to which its objectives were attained, independently of the amount of effort that was dedicated to it or whether unexpected external shocks altered the reform priorities of the country. Thus, for example, the drafting of a superb law would be considered unsatisfactory if the government did not adopt it or even if, having adopted it, failed to enforce it.

The Relevance of the Credits

6.4 *In this aspect, the credits were satisfactory.* Based on interviews carried out by IEG, the government believes that the credits addressed the most relevant issues in public sector management and that the linkage between those and the sustainability of macro stability was strong and clear.

6.5 The credits were thoroughly prepared, based on solid economic and sector work. Certainly, their objectives were scattered across a wide variety of fields and institutions. Although the actions they supported were dispersed, they all contributed to a single objective and were linked together. Moreover, the government had made clear that it was committed to move on all fronts and had established a legal framework that was suitable for practically all the aspects of the operation. It had also carried out several other actions that proved ownership of the Project.

6.6 This conclusion coincides with other assessments, such as those in the implementation reviews. In addition, the PSMTAC was subjected to a quality assurance review and it got a satisfactory rating for quality at entry. This report disagrees with only one aspect of quality at entry: that of the design of the credit, which is discussed in the next subsection.

The Design of the Project

6.7 *In this aspect, the credits were unsatisfactory.* This rating is based on two reasons. First, the credits did not adequately address the importance of introducing the appropriate market framework in two key outcomes that were expected from the loan: the privatization of Hondutel and the outsourcing of electricity distribution. Second, the strong reliance on inputs rather than outcomes in the conditions of disbursement implied that important objectives of the credits were not assured even though the conditions for disbursement were attained.

Supervision and Disbursements

The PSMSAC

6.8 *This report rates the disbursements of the PSMSAC as unsatisfactory.* The tranche release of this credit could not be justified based on the compliance with the structural objectives set by Board approval. Despite the changing country context generated by Hurricane Mitch, the waivers given to the third tranche conditions regarding the privatization of telecommunications and electricity cannot be justified within the internal logic of the credit because the entire performance of the credit depended on their accomplishment. Without these outcomes, all the studies elaborated to attain them had no practical consequence.

The PSMTAC

6.9 *Regarding the criteria used to disburse the PSMTAC, this report rates it as satisfactory.* Disbursements were authorized in a timely manner and according to what had been established in the credit agreements. *Yet, regarding the procedures used for disbursements, this report rates it as unsatisfactory.* The problems derived from the use of a single revolving fund with many executing agencies which hindered implementation as withdrawals of some executing agencies emptied the fund and delayed the withdrawals of the others. The use of a single revolving fund is standard procedure in the Bank and IDA. This, however, does not detract from the problems caused to the executing agencies. The Bank and IDA should look for a compromise in cases when there are many executing agencies for one Project.

The PSMSAC Macro Economic Performance

6.10 *This aspect of PSMSAC was satisfactory.* As noted before, the improvement in the country's macroeconomic performance in the first two years of the operation cannot be attributed to the credit. However, the government used the PSMSAC funds to support a progressive reduction of the fiscal deficit and the rate of inflation, subsequent to the

deterioration of the fiscal situation as a consequence of the devastation produced by Hurricane Mitch.

The PSMTAC Components

6.11 Overall, the outcome of the structural components was unsatisfactory. The following paragraphs rate in more detail each of the activities contained in this component.

The Private Provision of Public Goods

6.12 *This component was unsatisfactory.* The objectives were not fully achieved. Of the three areas that the credits supported, one (electricity) was dropped without any achievement; the second (telecom), was also dropped after the state-owned company was taken to the market and failed to attract offers at the high reservation price that the government had set for it; and the third (airports), was privatized but private participation did not provide the expected benefits.

6.13 While there were problems in implementation, there was a problem of design despite the use of best practices at the time. In all three areas, IDA aimed at privatization in itself rather than at improving the services provided. In the case of telecom and electricity, the fundamental objective should have been greater efficiency and lower prices under a suitable regulatory framework rather than privatization as an end in itself. A company privatized in this environment would have had to compete with other operators, not just reducing the investment needs of the government but also eliminating monopoly rents. In Honduras, the reforms involved the private sector in the provision of services, but turned them into providers of the still existing state-owned company. This kept some monopoly power in place, and the sectors have remained underdeveloped relative to those of neighboring countries in terms of number, diversity, and quality of services. In the case of electricity, the supply has been adequate but the costs to ENEE have been very high because the prices contracted with private entrepreneurs have been excessively high.

6.14 In *telecommunications*, the outcome was *moderately unsatisfactory*. Almost ten years after the initiation of the credits, Hondutel is still a public sector company and the telecom market is not completely open to competition. Nonetheless, the 1995 telecommunications law did set in motion important avenues for competition, particularly due to the entry of cellular providers.

6.15 In *electricity*, the outcome was *unsatisfactory*. ENEE retains its monopolistic powers, remains the main source of policy making in the sector, and is not financially solvent.

6.16 In *airports*, the outcome was also *unsatisfactory*. The design failure in airports was to include in the contract compromises that the government of Honduras could not realistically comply with.

Administrative Reforms

6.17 *The outcome of this activity was unsatisfactory.* The most important parts of this activity, the reform of social security and the rationalization of the salary regime, were unsuccessful. While some progress was made in terms of creating a database and

classifying positions, the inconsistencies between different groups making up about two-thirds of civil servants, remain in place and may increase over time. In one case, that of teachers and physicians, the compensation increases are creating fiscal pressures that will continue to build unless further reforms are implemented.

Public Sector Management Reforms

6.18 The outcome of the objective of creating a *comprehensive human resources management system* is unsatisfactory. The system is still unable to provide the basic information needed for the management of public sector human resources. The outcome of the *Information System of the Secretariat of Finance* was also *unsatisfactory*. The system became untenable and, given experiences gained, work started on a new one. The rating for *Public Investment Management* is *satisfactory*. While the computerized systems that were established to support investment decisions suffered from some of the same problems as the SIAFI, the data are there and can be used more easily than those of the SIAFI because it was a simpler system.

Public Procurement

6.19 The rating of this activity is *satisfactory*. The system of procurement is still in need of improvements. However, the main objective of the loans, to decentralize procurement, was achieved.

Overall Rating

6.20 While there were many positive aspects to these operations, their overall rating is unsatisfactory. The benefits that Honduras has derived from it are modest and may not be sustainable in the long run. This conclusion is based on two observations: first, the problems that existed at the time of the approval of the operations remain in place; second, the difficulties that must be overcome to resolve them are formidable. Also, in some areas, such as electricity, the privatization of parts of the activities without enough attention to the introduction of the appropriate market framework created vested interests that have resisted the liberalization of the markets.

6.21 Some of the elements that failed during the implementation of the credits are being pursued today, so that their failure can be considered temporary. These include, prominently, the design of the new SIAFI and its coordination with the investment and procurement systems that were created under the credits. They also include the privatization of airports. In some sectors, events are moving in such a way that liberalization will be inevitable. This is the case, for example, with the telecom reform. As the *de jure* monopoly has ended, market forces are beginning to make way for greater competition. Given these pressures, the government could open the market completely, which would require issuing the necessary regulations, even the privatization of Hondutel. There is the possibility of further delays to ensure survival of this company by reinforcing its monopoly powers through regulations that effectively block the emergence of further competition.

7. The Lessons

7.1 There are at least four lessons that can be drawn from these operations:

- In retrospect, this wide-ranging and multi-tranche operation that was typical of development lending operations at the time was too ambitious given the institutional framework of the country. IDA has largely learned from these lessons and moved away from this type of lending in favor of more modest single-tranche programmatic lending.
- While government ownership was solid at the outset, IDA did not adequately ascertain the strength of the many competing interest groups opposed to the operation. Assessing the broader political context for reform is important in assessing its likely implementation and sustainability.
- The market framework and strategy for reform in the energy sector should not focus solely on privatization and competition. While this model has worked well in many countries, the size and institutional features of the market may necessitate an interim strategy of partial privatization and regulation.
- The disbursement of final tranches in structural adjustment operations should be tied to the desired outcomes, not inputs, and IDA should avoid granting waivers connected to these outcomes. This lesson also applies to one-tranche programmatic operations, which also should focus on outcomes, not inputs.

Annex A. Basic Data Sheet

PUBLIC SECTOR MODERNIZATION STRUCTURAL ADJUSTMENT CREDIT (CREDIT 2816)

Key Project Data (amounts in US\$ million)

	<i>Appraisal estimate</i>	<i>Actual or current estimate</i>	<i>Actual as % of appraisal estimate</i>
Original commitment	81.4	122.9	1.51
Total cancellation			
Total project cost	81.4	122.9	1.51
Cancellation			

Project Dates

	<i>Original</i>	<i>Actual</i>
Departure of Appraisal Mission	06/13/1995	06/13/1995
Board approval	02/08/1996	02/08/1996
Signing	04/11/1996	04/11/1996
Effectiveness	07/11/1996	04/10/1997
Closing date	12/31/1998	11/30/2001

Staff Inputs (staff weeks)

	<i>Actual/Latest Estimate</i>	
	<i>N° Staff weeks</i>	<i>US\$ ('000)</i>
Pre-appraisal	17.9	48.0
Appraisal/Negotiation	24.60	65.0
Supervision	152.71	396.28
ICR	4.0	6.4
Total	199.21	515.68

Mission Data

	<i>Date (month/ year)</i>	<i>No. of persons</i>	<i>Specializations represented</i>	<i>Performance rating</i>	
				<i>Implementation Progress</i>	<i>Development Objective</i>
Identification/ Preparation	9/27/94- 10/7/94	7	Task Manager; Administrative Reform; Human Resource Management; Public Administration; Financial Management; Tax Policy and Administration Reform; Technology Specialist; Fiscal Reform; Social Security	S	S
Appraisal/ Negotiation	6/13/95- 6/23/95	15	Task Manager; Human Resource Management; Institutional Restructuring; Social Security; Public Management; Macroeconomic and Fiscal Environment; Education	S	S
	3/6/96- 3/11/96	5	Task Manager; Telecommunications; Aviation; Ports; Institutional Restructuring; Human Resources; Financial Management	S	S
Supervision	6/16/97- 6/20/97	6	Task Manager; Telecommunications; Airports; Institutional Restructuring; Social Security; Human Resources	S	S
	10/20/97- 10/31/97	7	Task Manager; Telecommunications, Electric Sector, Institutional Restructuring; Procurement; Human Resources; Financial Management; Civil Aviation	S	S
	6/01/98-	6	Task Manager; Financial Management; Human Resources; Telecommunications; Electricity; Institutional Restructuring; Privatization	S	S
Completion	6/01/98- 6/05/98	6	Task Manager; Telecommunications; Electric Sector; Institutional Restructuring; Social Security; Human Resources; Financial Management; Civil Aviation	S	S
	1/18/99	5	Task Manager; Telecommunications; Privatizations; Human Resources; Electricity; Institutional Restructuring; Public Finance	S	S
	1/29/01- 6/23/01	6	Task Manager; Telecommunications; Regional Economist; Resident Representative; Operational Analyst, Integrated Financial Management System	S	S
	6/18/01- 6/23/01	9	Task Manager; Human Resources; Regulatory Reforms; Privatizations; Personnel Evaluations; Civil Society; Integrated Financial Management System	S	S

Other Project Data

Borrower/Executing Agency:

FOLLOW-ON OPERATIONS

<i>Operation</i>	<i>Credit no.</i>	<i>Amount (US\$ million)</i>	<i>Board date</i>
Economic and Financial Management Project	3414	19	09/12/2000

**PUBLIC SECTOR MODERNIZATION TECHNICAL ASSISTANCE CREDIT
(CREDIT 2814)**

Key Project Data (*amounts in US\$ million*)

	Appraisal estimate	Actual or current estimate	Actual as % of appraisal estimate
Original commitment	9.6	8.75	.91
Total cancellation			
Total project cost	9.6	8.75	.91
Cancellation			

Project Dates

	Original	Actual
Departure of Appraisal Mission	04/14/1995	04/13/1995
Board approval	02/08/1996	02/08/1996
Signing	04/11/1996	04/11/1996
Effectiveness	07/11/1996	07/11/1996
Closing date	06/30/2000	06/30/2000

Staff Inputs (staff weeks)

	Actual/Latest Estimate	
	N° Staff weeks	US\$ ('000)
Pre-appraisal	32.00	72.10
Appraisal/Negotiation	19.70	37.90
Supervision	103.22	236.21
ICR	3	15.0
Total	157.92	361.21

Mission Data

	<i>Date (month/ year)</i>	<i>No. of persons</i>	<i>Specializations represented</i>	<i>Performance rating</i>	
				<i>Implementation Progress</i>	<i>Development Objective</i>
Identification/ Preparation	6/9/94- 6/17/94	8	Task Manager; Health Specialist; Legal Counsel; Education; Human Resources; Civil Service; Tax Policy Reform; Public Administration; Fiscal Analysis; Public Administration Reform; Procurement	S	S
Appraisal/ Negotiation	6/13/95- 6/23/95		Task Manager; Health Specialist; Legal Counsel; Education; Human Resources; Information Systems; Civil Service; Tax Policy Reform; Public Administration; Fiscal Analysis; Public Administration Reform; Procurement	S	S
Supervision	3/12/96- 3/15/96	1	Social Security Reform Specialist	S	S
	11/4/96- 11/8/96	1	Privatization	S	S
	1/30/97- 2/5/97	1	Task Manager; Financial Management; Human Resources; Public Procurement, Institutional Restructuring	S	S
	6/27/97- 7/4/97	1	Privatization (Telecommunications)	S	S
	10/27/97- 10/31/97	7	Task Manager; Telecommunications; Civil Aviation; Electricity; Institutional Restructuring; Human Resource Management; Public Finance Management; Procurement	S	S
	1/18/98- 1/22/98	6	Task Manager; Telecommunications; Civil Aviation; Privatization; Electricity; Institutional Restructuring; Human Resource Management; Public Finance Management	S	S
	5/29/98- 6/5/98	5	Task Manager; Telecommunications; Civil Aviation; Electricity; Institutional Restructuring; Human Resource Management; Public Finance Management	S	S
	4/6/99- 4/10/99	1	Power Engineer	S	S
Completion					

Other Project Data

Borrower/Executing Agency:

FOLLOW-ON OPERATIONS

<i>Operation</i>	<i>Credit no.</i>	<i>Amount (US\$ million)</i>	<i>Board date</i>
Economic and Financial Management Project	3414	19	09/12/2000

Annex B. PSMSAC: Compliance with Disbursement Conditions and Attainment of Objectives

The table below shows the conditions of disbursement by component, the judgment on compliance as reported by the credit's implementation review and IEG's judgment on the attainment of the objectives of the component.

	<i>Conditions</i>	<i>ICR rating</i>	<i>Objectives attainment</i>
(a) Private Sector Participation in Public Services			
a.1 Telecommunications			
First Tranche (Board Presentation)	Approval by Congress of the Framework Law for the Telecommunications Sector including amendments to the Hondutel Organic Law.	Accomplished	Privatization failed. Preparation of the company was inadequate, as pricing problems arising from cross-subsidization were not solved in advance. Additionally, the company was loaded with hidden social costs and the reservation price was too high. Subsequent private participation did not end the monopoly of Hondutel even in areas where the 1995 law mandated its termination.
Second Tranche	Issue and put into effect the regulations of the Framework Law for the Telecommunications Sector. Assign a budget for and establish operations of the regulatory agency (CONATEL).	Accomplished Accomplished	
Third Tranche	Issue formal bidding documents to solicit bids for investment in the enterprise(s). Hondutel established according to the Law to operate basic telephone services (local, long-distance and international) with coverage of the South-Center and North-West regions including the cities of Tegucigalpa and San Pedro Sula. The enterprise(s) established by Hondutel to operate basic telephone services (local, long-distance and international) in the South-Center and North-West regions including the cities of Tegucigalpa and San Pedro Sula are managed and controlled by investors (other than the government) and are substantially owned by these investors.	Waived (Subsequently Accomplished) Waived (Justified)	
a.2 Electric Power			
First Tranche (Board Presentation)	Define a new electricity tariff structure and make a public commitment to implement the new structure on a permanent basis.	Accomplished	The main objective of the exercise, the privatization of at least one distribution area was waived.
Second Tranche	Approve strategy satisfactory to IDA to determine the geographical regionalization of electric power distribution across the national territory to facilitate private sector participation.	Accomplished	
Third Tranche	Award at least one contract for private sector participation in the distribution of electric power in accordance with the study carried out by second tranche. Such contract would cover at least 35 percent of consumers in the national territory.	Waived	

	<i>Conditions</i>	<i>ICR rating</i>	<i>Objectives attainment</i>
a.3 Civil Aviation			
First Tranche (Board Presentation)	The Aviation Law and the Law for the Honduras Enterprise of Airports and Air Navigation Services to substantially increase private sector participation was presented to congress.	Accomplished	The airports were privatized through a concession. However, the concession had to be revoked. A new concession is being negotiated.
Second Tranche	Enter into a concession contract for the management and operation of at least one of the airports with regular international traffic; or enter into at least one concession contract to operate some of the Airport Services in at least two of the airports with regular international traffic.	Waived (Subsequently Accomplished)	
Third Tranche	Enter into a concession contract for the management and operation of one of the airports with regular international traffic; or enter into at least one concession contract to operate some of the Airport Services in at least two of the airports with regular international traffic. This is in addition to what was already accomplished for the second tranche.	Accomplished	
(b) Administrative Reform			
b.1 Institutional Restructuring			
First Tranche (Board Presentation)	Present to Congress the new General Law of Public Administration.	Accomplished	The restructuring of several units were accomplished. The premature dismantling of the Secretariat of Planning resulted in coordination problems.
	Emanate Presidential Decree to establish the legal basis for the reform including the approval of institutional restructuring plans for priority entities (Secretariats of Education, Health, Communications and Transport, and Natural Resources, and JNBS/PANI and Economics and Finance Secretariats).	Accomplished	
	Restructuring plans will be reflected in the proposed budget for 1996. Implement the institutional restructuring plans in accordance with the benchmarks established in such plans.	Accomplished	
Second Tranche	Implement the institutional restructuring plans in accordance with the benchmarks established in such plans.	Accomplished	
Third Tranche	Implement the institutional restructuring plans in accordance with the benchmarks established in such plans.	Accomplished	
b.2 Rationalization of Employment and Salary Regimes		Accomplished	Salary structures remain severely distorted by the special regimes granted to groups of employees representing about 2/3 of civil service. The
First Tranche (Board Presentation)	Rationalization of public employment and salary structures in accordance with the benchmarks established in the action plans for the Reform in the Civil Service Regime of the Central Government and the Decentralized Institutions	Accomplished	

	<i>Conditions</i>	<i>ICR rating</i>	<i>Objectives attainment</i>
Second Tranche	Comply with the measures for rationalization of public employment and salary structures in accordance with the benchmarks established in the action plans for the Reform in the Civil Service Regime of the Central Government and the Decentralized Institutions.	Accomplished	privileges granted to teachers and physicians are such that they threaten the country's macroeconomic stability.
Third Tranche	Comply with the measures for rationalization of public employment and salary structures in accordance with the benchmarks established in the action plans for the Reform in the Civil Service Regime of the Central Government and the Decentralized Institutions.	Accomplished	
(c) Reforms of Public Management			
c.1 Human Resource Management			
First Tranche (Board Presentation)	Agree on an action plan for the development of a comprehensive Public Sector Human Resources Management and Effective Control Mechanisms.	Accomplished	Job classification and database of positions accomplished. Human resource management remain severely distorted by the special regimes granted to groups of employees representing about 2/3 of civil service. The
	Implement the plan in accordance with the benchmarks established in such plan.	Accomplished	privileges granted to teachers and physicians are such that they threaten the country's macroeconomic stability. The government still relies on censuses to ascertain the number of civil servants in parts of the public sector. The new law that would create the new system is stalled in Congress.
Second Tranche	Implement the action plan for Human Resources Management and Control in accordance with the benchmarks established in such plan.	Accomplished	
Third Tranche	Implement the action plan for Human Resources Management and Control in accordance with the benchmarks established in such plan.	Accomplished	
c.2 Financial Management and Public Investment Programming			
First Tranche (Board Presentation)	Agree on an action plan for the Modernization of Financial Management and Investment Programming.	Accomplished	The SIAFI program became so unwieldy that it had to be scrapped. The government is developing a new SIAFI. Investment programming database will be integrated with the new SIAFI.
	Design integrated systems of financial management and investment programming.	Accomplished	
Second Tranche	Implement the action plan for Modernization of Financial Management and Investment Programming in accordance with the benchmarks established in such plan.	Accomplished	
Third Tranche	Implement the action plan for Modernization of Financial Management and Investment Programming in accordance with the benchmarks established in such plan.	Accomplished	