Report Number : ICRR13964

IEG ICR Review
Independent Evaluation Group

1. Project Data :		**Date Posted :**	11/05/2012	
Country :	Honduras			
	Is this Review for a Programmatic Series?			○ Yes ● No
Series ID :				
First Project ID :	P121220		**Appraisal**	**Actual**
Project Name :	Emergency Recovery Development Policy Credit	**Project Costs (US$M):**	74.7	74.7
L/C Number:		**Loan/Credit (US$M):**	74.7	74.7
Sector Board :	Economic Policy	**Cofinancing (US$M):**		
Cofinanciers :		**Board Approval Date :**		11/09/2010
		Closing Date :	11/15/2011	11/15/2011
Sector(s):	Central government administration (70%); Power (20%); General education sector (10%)			
Theme(s):	Public expenditure; financial management and procurement (60%); Tax policy and administration (40%)			
Evaluator :	**Panel Reviewer :**	**ICR Review Coordinator :**	**Group:**	
Aghassi Mkrtchyan	Robert Mark Lacey	Navin Girishankar	IEGPS2	

2. Project Objectives and Components:

a. Objectives:

The Emergency Recovery Development Policy Credit's (ERPD's) overall objective was to assist the Government in "bringing public finances back to a sustainable path" (Program Document, page i). This goal was to be achieved through 5 sub-objectives laid out in the policy matrix -- (i) closing tax loopholes and widening tax base; (ii) improving tax administration; (iii) improving public sector human resource management and rationalizing the wage bill to create fiscal space; (iv) reforming the power sector structure to contribute to financial sustainability of the state-owned electricity company; and (v) resolving outstanding public sector arrears and investigating shortcomings of the Integrated Financial Management or SIAFI (Program Document, Annex 2, page 58). The Financing Agreement does not contain a statement of objectives .

For the purposes of this ICR review, IEG uses the overall objective set out in the Program Document, and assesses relevance and efficacy in relation to the five sub -objectives listed in the policy matrix.

b. If this is a single DPL operation (not part of a series), were the project objectives/ key associated outcome targets revised during implementation?

No

c. Policy Areas:

(i) Tax reform : This policy area focused on closing tax loopholes, widening the tax base and improving tax administration through elimination of tax credits under value -added tax, introduction of flat 10 percent income tax on dividends and capital gains, implementation of reformed tax code, facilitating taxpayers' compliance by creating incentives for using electronic payments . The program aimed to increase the revenues of the Central Government to 16.1 percent of GDP in 2011, compared to the baseline of 14.4 percent in 2009; to increase the number of taxpayers using electronic payment system by at least 10 percent in 2010.

(ii) Civil Service Reform : The focus of this policy area was on improving public sector human resource management and rationalizing the wage bill to create fiscal space through keeping the overall wage bill unchanged in nominal terms in 2010 and 2011. The program aimed at reducing the wage bill by at least 0.5 percent of GDP in 2010.

(iii) Reform of power sector tariffs : Reforms aimed at designing a power sector tariff structure, by eliminating electricity subsidies for residential users, and increasing the tariffs, that would contribute to the financial sustainability of the National Electricity Company (ENEE). It was expected that (a) the increase in electricity tariffs will raise ENEE's monthly revenues by US$ 6 million; (b) the restructuring of the direct electricity subsidy will generate savings for the Government of US$ 23 million monthly; and (c) ENEE will eliminate its arrears with private sector power generators.

(iv) Strengthening public financial management and transparency : The program sought to resolve outstanding public sector arrears and investigate the shortcomings of the SIAFI through an audit to identify weaknesses of the financial management system. The target in this area was to audit and resolve about 0.3 percent of GDP worth of previously unaccounted and unpaid transactions .

d. Comments on Project Cost, Financing, Borrower Contribution, and Dates:

The program provided US $ 74.7 million to the Government of Honduras. It was appraised in September 2010 and approved by the Board on November 15, 2010. It became effective in December 2010. The credit was disbursed in full and the program was closed as scheduled on November 15, 2011.

3. Relevance of Objectives & Design:

a. Relevance of Objectives:

IEG assessed the relevance of objectives as **substantial** for the following reasons:

- In 2008-09, Honduras sought to weather a period of political turmoil along with the effects of the global financial crisis. Taken together, these crises served to exacerbate long -standing problems of governance and security that have impeded Honduras' growth and development prospects . Following the period of political turmoil, the new Government sought the World Bank's support in its efforts to stabilize the economy and re-establish the groundwork for growth. The ERDPC served as the main instrument of Bank support for the new Government's fiscal stabilization efforts.
- In its strategy and it the Bank's Interim Strategy Note, the Government indicated two immediate priorities -- restoring macroeconomic stability and reigniting growth, and addressing the needs of the poorest segments in society (Honduras Interim Strategy Note, 2010). The ERDPC served as the only lending operation in the 2010 Interim Strategy and explicitly supported the Government's goal of restoring macro and fiscal stability following a substantial deterioration in the country's fiscal outlook .
- The priorities set out in the ERDPC were appropriate to Honduras' circumstances . While some weakening of the fiscal position is usually anticipated as part of any Government's counter -cyclical policies, Honduras' fiscal expansion was undertaken in parallel with a suspension of international development assistance and, therefore, was not sustainable. Restoring fiscal solvency required immediate actions by the new Government through a coordinated program of revenue mobilization, civil service wage reform, quasi -fiscal sector reform, as well as public financial management.

b. Relevance of Design:

IEG assessed the relevance of design as **substantial** based on a review of both strengths and weaknesses .

Key design strengths were as follows:

- Even though the Bank team was ready to engage the Government in a longer term dialogue supported by serial budget support operations, it was aware of the risks and uncertainties inherent in the fragile political environment that prevailed at the time of preparation. It therefore opted for a pragmatic design that used a single tranche, stand-alone operation to support immediate fiscal stabilization, The operation was prepared rapidly in parallel with the Interim Strategy Note, which outlined the framework of Bank support to Honduras for the upcoming 12 months.

- The causal chain, reflected in the policy matrix, generally linked objectives to outcome indicators in a convincing manner. The operation was designed around four mutually-reinforcing themes (mentioned above), all of which were relevant to Honduras' fiscal stabilization agenda. The design of specific reform actions in each policy area generally reflected a strong analytical foundation.

- The program benefited from the coordinated support of multiple partners, and was prepared in close consultation with the International Monetary Fund (IMF), the Inter-American Development Bank (IDB) and the Central American Bank for Economic Integration (CABEI).

Despite these strengths, there were some weaknesses:

- The causal links between objectives, actions, and outcomes, were weaker in the area of tax administration. The results framework did not track the link between the legislative changes (and specifically the prior actions such as draft legislation and the introduction of an electronic system of tax returns) and the expected outcomes. For instance, it is not clear whether and how reduced transaction costs would help to improve tax compliance and how the outcome indicator provided in the matrix can measure these changes.

- The program did not address governance issues in tax administration (especially issues of human resource management) that hindered revenue performance. Also, while most of the ERDPC was supported by robust analytical underpinnings, political economy analysis of the governance of tax administration as well as the underlying incentives preventing the resolution of the arrears problem or those contributing to SIAFI's shortcomings may have helped improve design. In fact, the need for this kind of analysis in this area has been subsequently recognized in a 2011 technical assistance project. The project emphasizes political economy analysis and a public communication strategy as the basis for robust tax administration reforms.

4. Achievement of Objectives (Efficacy):

Efficacy of the overall objective -- "bringing public finances back to a sustainable path" -- is assessed through the achievement of the following four sub-objectives in the policy matrix:

- **Closing tax loopholes and widening the tax base (modest)**: Revenue mobilization has traditionally been a major challenge for Honduras, and recent economic and political crises exacerbated the problem, In 2009, tax revenues declined to 14.4 percent of GDP from 16.1 percent in 2008. As part of the stabilization and growth plan, the Government moved to widen the tax base through policy changes such as the elimination of tax credits and exemptions under value-added tax, and the introduction of a flat 10 percent income tax on dividends and capital gains. Key legislative changes, which also served as prior actions for ERDPC, were expected to bring the tax to GDP ratio back to 16.1 percent, which was attained in 2008. However, by 2011, tax to GDP ratio of 15.1 percent was one percentage point less than projected. The ICR mentions slower than expected economic growth in 2011 as the main factor that affected tax performance. Yet, by the end of 2011, the Honduran economy had fully recovered, and real GDP was 4 percent higher than in 2008. The lackluster revenue performance therefore may have results from other factors such as weaknesses in tax administration (see below).

- **Improve tax administration (modest):** The program's tax administration pillar was built around two prior actions -- submitting the Law for tax improvement to the Parliament; and expanding the electronic tax declaration system. With regard to the first area, the program does not have a results indicator and the ICR does not discuss the status of the draft law submitted to the Parliament. With regard to the establishment of the electronic payment system, following the prior action the number of tax returns submitted electronically had increased by more than 40 percent (the target). Yet shortcomings in the design, including the choice of the result indicator, do not allow an assessment of whether these reforms and reduced transaction costs for taxpayers have contributed to better tax compliance.

- **Improve public sector human resource management and rationalize the wage bill to create fiscal space (high):** Controlling the excessive public sector wage bill was important for regaining fiscal sustainability in Honduras. Due to political factors, the wage bill increased to unsustainable levels in 2008-09, mostly driven by ballooning teacher wages. The large numbers of redundant teachers who continued to receive wages from the public purse, as well as widespread fraud in the civil service served to inflate the wage bill. Through its support for an audit of education system and identification of redundant teachers (prior actions), ERDPC helped address these challenges. It also helped the Government put an effective freeze on the nominal wage bill. As a result, the wage bill was reduced to 9.7 percent of GDP in 2011 from 11 percent in 2009 significantly contributing to the improved fiscal situation in 2011.

- **Reform the power sector structure to contribute to the financial sustainability of the state -owned electricity company (substantial)**: ERDPC supported the financial sustainability of the state-owned electricity company by lowering the threshold for electricity subsidies, increasing tariffs, and eliminating arrears of public sector consumers to the electricity company. It was envisaged that these measures would result in extra revenues for the electricity company amounting to US$ 6 million per month, reduced subsidies by the Government to the electricity company of US$ 23 million per year and elimination of the company's arrears with private sector power generators. The expectations in terms of extra revenues have been fully met. However, the target for reducing subsidies was only partially attained, due to higher than expected fuel prices in 2011. Total subsides paid to the electricity company were reduced by US$ 16 million instead of projected 23 million. During the program implementation the arrears with power generators were cleared and the practice of delays in payments had stopped. Overall, the reforms in this policy area contributed to improving the financial viability of the state electricity company with positive implications for fiscal sustainability.

- **Resolve outstanding public sector arrears and investigate shortcomings of the Integrated Financial Management system (SIAFI) (negligible)**. The ERDPC helped initiate an audit of public sector arrears with the private sector and resolve the issue of disputed arrears amounting to about 0.3 percent of GDP. The audit was conducted by a firm selected on competitive basis and the results have been submitted to the Superior Court of Auditors for further actions. However, the ICR does not mention any follow-up actions taken with regard to the disputed arrears and investigation of shortcomings of SIAFI. The program documents do not discuss whether the issue of disputed arrears had been resolved. The lack of progress in this area creates risks for overall efficiency of resource use.

Overall macroeconomic performance: Under the program, Honduras' macroeconomic performance improved. Following the recovery of the global economy and an improved political situation, growth resumed in 2010, accelerating further in 2011 to 3.5 percent. With the help of measures under ERDPC and the 18 months Stand-by Arrangement with the IMF, the budget deficit was reduced to around 3 percent of GDP. In spite of substantial improvements, Honduras remains vulnerable to external shocks and continues to suffer from weak revenue mobilization capacity -- both of which pose risks to the sustainability of its public finances.

5. Efficiency (not applicable to DPLs):

6. Outcome:

IEG's outcome rating of **moderately satisfactory** reflects the substantial relevance of ERDPC's objectives and design, its high achievements in rationalizing the public sector wage bill, and its substantial improvements in the financial situation of the electricity company, but also the operation's only modest progress in widening the tax base and strengthening tax administration, and its negligible achievement in resolving public arrears. Despite the progress made, the ERDPC contributed to the overall stabilization of Honduras' public finances.

a. Outcome Rating: Moderately Satisfactory

7. Rationale for Risk to Development Outcome Rating:

Honduras is facing serious political, macroeconomic and institutional risks that may undermine the results achieved by the Bank program of the Government. The political situation remains fragile and country is yet to reach a consensus between different social groups on key policy issues, including taxes and public expenditures. Honduras is a small, open economy, heavily exposed to external risks, including fuel prices and global economic environment that could undermine fiscal sustainability and economic stability. Government's revenue mobilization capacity remains weak, keeping the tax to GDP ratio below its potential. Shortcomings in public financial management also undermine effectiveness of resource use.

a. Risk to Development Outcome Rating: High

8. Assessment of Bank Performance:

a. Quality at entry:

Following the resolution of the political crisis in Honduras, the Bank moved expeditiously to re -engage with the country. Substantial expertise and technical assistance were put in place to develop a program focused on stabilization of public finance, covering a wide range of issues including tax policy and administration, civil service wage bill, quasi-fiscal sector and public sector arrears. This includes the Fiscal Emergency Non-lending Technical Assistance and the preparation of Improving Public Sector Performance Technical Assistance Project that overlapped with the preparation of the DPC.

The Bank team worked very closely with the Government and other partners to put together a reform program in a relatively short time. There were shortcomings in the design of the component on tax administration that affected program implementation following the submission of the draft law on improving tax administration to the Parliament. Given the high degree of political sensitivity of tax administration reforms, political economy analysis could have helped to improve the design of the program and to contribute to the achievement of objectives. The importance of this kind of analysis was subsequently recognized in a 2011 technical assistance project on improving public sector performance. The project emphasizes political economy analysis and a public communication strategy as the basis for more robust tax administration reforms.

Quality-at-Entry Rating: Moderately Satisfactory

b. Quality of supervision:

Supervision was carried out through regular monitoring of economic and fiscal developments, and through a number of visits to Honduras by the Bank team. Program supervision overlapped with preparation of the second DPO. The team could have been more pro-active in resolving disputed arrears, and ensuring sufficient follow-up actions after submission of the results of the audit of arrears to the Superior Court of Auditors.

Quality of Supervision Rating: Moderately Satisfactory

Overall Bank Performance Rating: Moderately Satisfactory

9. Assessment of Borrower Performance:

a. Government Performance:

Throughout program preparation and implementation the Government remained fully engaged undertaking many important actions that can serve as building blocks for deeper economic reforms in the future. There was insufficient follow-up on the issue of disputed budgetary arrears.

Government Performance Rating: Moderately Satisfactory

b. Implementing Agency Performance:

The Ministry of Finance (SEFIN) was responsible for coordinating actions of other agencies and progress reporting, and it led the program effectively.

Implementing Agency Performance Rating: Satisfactory

Overall Borrower Performance Rating: Moderately Satisfactory

10. M&E Design, Implementation, & Utilization:

a. M&E Design:

All policy areas had outcome indicators with the exception of one of the prior actions in tax administration (submission of the draft law on tax administration to Parliament). It is therefore not possible to assess fully the program's achievements in tax administration. Indicators in most other areas selected for monitoring program implementation and results were appropriate and had established baseline values. However, the indicator on tax returns submitted electronically is not an adequate outcome indicator for understanding the impact of introduction of the electronic system on tax compliance. The M&E arrangements placed responsibilities for collecting data on the Ministry of Finance.

b. M&E Implementation:

M&E implementation was mostly adequate. The Ministry of Finance and the Bank had joint responsibilities in the preparation of periodic reports. A mid-year review was conducted in March 2011. The ICR does not report the status of the audit results regarding public sector arrears.

c. M&E Utilization:

The ICR does not report any utilization of the M&E system beyond monitoring program implementation.

M&E Quality Rating : Substantial

11. Other Issues

a. Safeguards:

No safeguards policies were triggered.

b. Fiduciary Compliance:

There were no issues with fiduciary compliance.

c. Unintended Impacts (positive or negative):

None reported.

d. Other:

12. Ratings:	ICR	IEG Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	Achievement of objectives is uneven. Tax policy and administration objectives were partially met (lower tax to GDP ratio, no follow-up on draft law on changes in tax administration), and the issue of disputed arrears of public sector with private sector was not resolved in a manner that was expected at the time of program approval.
Risk to Development Outcome:	Moderate	High	Honduras is facing high political, macroeconomic and institutional risks that may undermine the results achieved by the Bank program of the Government.
Bank Performance :	Satisfactory	Moderately Satisfactory	Design shortcomings adversely affected tax administration reforms, and

			follow-up on the results of the audit of disputed budgetary arrears was insufficient.
Borrower Performance :	Satisfactory	Moderately Satisfactory	Follow-up on the results of the audit of disputed budgetary arrears was insufficient.
Quality of ICR :		Satisfactory	

NOTES:
- When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
- The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

13. Lessons:

This Review supports the lessons that the ICR mentions, and adds the following :

- An emergency loan to a borrower that faces imminent fiscal stability risks should be focused primarily -- even exclusively -- on public finance issues.
- Resolving the issue of excessive public wages that undermines fiscal sustainability may be politically costly but possible, if there is sufficient political will and well organized communication strategy that explains long-term benefits of rationalizing civil service pay.
- Tax policy measures in many instances may be insufficient if they are not supported by necessary tax administration reforms. The example of Honduras indicates that although the Government was able to introduce politically difficult tax policy measures, their effectiveness was hampered by the lack of improvements in tax administration.
- The process of program preparation should be used for identifying areas where achievement of intended objectives may be difficult, and for making necessary arrangements in the design of the program to ensure sound program implementation. Further reliance on upstream political economy analysis can help tailor reforms to country conditions in a manner that is both pragmatic and monitorable.

14. Assessment Recommended?

○ Yes ● No

15. Comments on Quality of ICR:

The ICR provides detailed accounts and analysis on most of important aspects of the program, although more could have been said about shortcomings in design and implementation issues. In particular, the ICR does not mention the absence of an outcome indicator for one of the prior action in tax administration and does not discuss whether this contributed to the weak follow-up on the prior action during program implementation. In addition, the ICR does not discuss the lack of appropriate follow-up on audit results for public sector arrears. The ICR uses "achieved" and "partially achieved" ratings for assessing achievement of objective, which is typically used for target indicators and not for objectives. Notwithstanding these weaknesses, the ICR provides adequate information in a user-friendly fashion.

a.Quality of ICR Rating : Satisfactory