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PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL, INC

ASSESSMENT OF THE HONDURAS MUNICIPAL FINANCE SYSTEM AND PROPOSED ACTION PLAN

Prepared for

United States Agency for International Development/Honduras

Prepared by

Priscilla M Phelps

Robert B Kehew

PADCO, Inc.

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Executive Summary

Part I: The Purpose of the Assessment

The Office of Municipal Development and Democratic Initiatives (MDDI) in the Honduras Mission of the United States Agency for International Development (USAID) requested assistance that would enable the Mission to provide direction to the Government of Honduras (GOH), municipalities, and the financial sector in Honduras in the development of a more sustainable system of municipal finance The initial component of this assistance was an assessment of the current system for municipal finance in Honduras This report is the result of that assessment

The development of a "municipal finance framework" that would reflect the consensus of all players on how a more expanded system is to come about has been proposed as a focal point for the creation of a more sustainable municipal finance system in Honduras A major purpose of the present assessment is begin to build a base of knowledge on which the "framework for municipal finance" can be constructed It includes a description of the context for municipal finance and identifies key constraints in the current municipal finance system that will need to be addressed if municipalities are to have sustainable, long-term financing sources available to them in future years This report also proposes the steps to articulate and put in place the elements of a municipal finance framework and a sustainable financing system

1 Defining the Municipal Finance System

The objective in municipal finance system development is to create a financing system that provides both public and private financial resources on an ongoing basis, so that a) municipalities have their financing needs met, especially for essential services, and b) the services that result are affordable and available to the maximum number of people

One of the critical assumptions underlying this analysis is that market-based sources of financing must be tapped, at least for the most creditworthy municipalities, if the overall municipal finance system is to expand sufficiently to serve on a sustainable basis all the investment demands emerging in Honduras Another assumption is that a local currency financing system, rather than a system that raises funds in dollars or other foreign currencies, should be the priority Even in fairly developed financial systems, external debt is too costly (or too risky) for local governments

Municipal finance system development generally has two components

- municipal sector finance — strengthening the tax base, financial management, and financial condition or creditworthiness of local governments, and
- municipal finance systems — improving and expanding the system used by local governments to raise the financial resources

The process of municipal sector financial development is well under way in Honduras, therefore, the emphasis of this report is on improvements that are needed to improve the financing system, although a number of municipal sector issues are also addressed

2 The Basic System Requirements

Well-functioning municipal finance systems provide both commercial and noncommercial funding sources to finance projects The basic requirements of a municipal finance system and the objectives associated with each one include the following

- **Creditworthiness** Incentives exist to move local governments in the direction of greater creditworthiness, and the strongest municipalities are perceived as good credit risks
- **Information** A range of timely financial and other information about municipalities is available to creditors and others
- **Technical assistance** Municipalities have access to fairly priced technical assistance on municipal finance matters
- **Expanded funding, appropriately allocated** A coordinated, transparent strategy is in place for best use of concessionary funding Municipalities that work to improve their creditworthiness are rewarded with expanded funding
- **Innovation** A range of financing sources are available A variety of transactions and financial structures are in use and are widely understood by local governments
- **Legal/regulatory support** The legal and regulatory systems for municipalities, the financial sector, and the macroeconomy support municipal finance
- **Policy framework** A municipal finance policy or framework guides implementation
- **Public-private dialogue** A forum exists that encourages a public-private dialogue on municipal finance and invites private sector involvement in the development process

Part II: Findings of the Assessment

The assessment of the municipal finance system in Honduras addresses three components the municipal sector (its demand for revenues and capacity to access and manage such resources), the current municipal finance system, and a discussion of key constraints, in both municipal sector finance and the municipal finance system, on expansion of the system

1 The Municipal Sector

Quality information on municipal investment requirements is difficult to find in Honduras, only a small number of Honduras's 289 municipalities prepare multi-year capital investment plans Yet some inferences can be drawn about municipal investment requirements from the information that is available Honduran municipalities have significant demands for resources to finance capital investment, yet they face the challenge of improving the provision of important basic services in the face of high levels of poverty and rapid rates of urbanization

Honduras is a poor country, approximately 70% of its citizens live below the official poverty line Poverty levels affect capital investment requirements and make it difficult to recover the costs for investments in services that are made Rapid urban growth rates fuel the need for investment in municipal infrastructure Urbanization has been occurring at a faster rate in Honduras than in most other countries in Central America

Thirty percent of Hondurans lack access to safe water, and 34% lack access to sanitation. These levels are roughly similar to the rest of Central America, where 34% lack access to potable water and 24% lack access to sanitation services. Provision of networked water and wastewater services in urban areas has stagnated over the last 20 years. Increasing reliance on non-network strategies for providing both potable water and sanitation services suggests a shortfall in the financing of these key municipal services.

The ability of municipalities to raise investment resources is affected by their own financial condition, as well as the shortcomings of the system. Municipal revenue levels reflect both available revenue sources and local officials' ability and commitment to raise municipal revenues. Total municipal income in Honduras stood at US$62.8 million in 1992. This represented about 2% of the gross domestic product (GDP), a relatively high number for the region. But because GDP is relatively low in Honduras, municipalities in other countries receive more resources in both absolute and per capita terms.

Honduras is relatively decentralized fiscally for the region. In 1995, Honduran municipalities' share of total government spending exceeded levels in Costa Rica, Panama, Nicaragua, El Salvador, and Guatemala.

Together, current income and capital income have to pay for municipalities' current expenditures as well as support capital investment. The Honduran municipal sector obtains its resources from a diverse set of revenue sources and is not excessively reliant on external sources of revenue. In Honduras, 59.4% of total revenues stemmed from local taxes, user charges, and a betterment levy (*contribución por mejoras*), with the intergovernmental transfer contributing to the remainder.

Sources of ordinary income available to local governments for operating purposes include:

- tax on industry, commerce, and services (48.7% of income generated by taxes and the betterment levy),
- real property tax (20.6%),
- personal tax (5.1%),
- other taxes (*impuesto por explotacion de recursos, impuesto pecuario, impuesto a billares y productos controlados*, etc.) (16.1%),
- betterment levy (9.5%),
- user charges, and
- intergovernmental transfer (no more than 10% of total).

The law restricts the use of the various sources of income in a way that tends to encourage capital investment. Capital investment as a percent of total expenditures has generally increased over time. The Municipal Law requires at least the following resources be applied to capital investment:

- at least 50% of current income to be applied for non-operating expenses, including capital investment,

- betterment levy,
- donations and transfers (including at least 90% of intergovernmental transfer),
- loan proceeds,
- bond proceeds, and
- all extraordinary income

2 The Current Honduran Municipal Finance System

The current system for infrastructure financing by municipalities in Honduras has significant limitations Participants in the system do not conceptualize the municipal finance system as a "system" *per se*, nor are the limitations addressed systematically There is minimal coordination at the policy level, or between funding sources, and few incentives for the private financial sector to lend for municipal purposes

2 1 Funding Sources for Municipal Capital Investment

No explicit, coherent municipal finance policy exists in Honduras under which municipal project financing is provided A number of local governments in Honduras are creditworthy enough to borrow or are receiving the assistance needed to become creditworthy (at least 30, it is estimated), yet the majority of funding available in the system is in the form of grants, which are allocated largely on the basis of need, rather than creditworthiness The limited concessionary debt funds are allocated on a similar basis A small amount of short-term bank financing does take place

Funding for municipal projects in Honduras comes from either public sector or concessionary funding sources, or from more limited private sources The public and concessionary sources include

- locally generated funds,
- central government transfers,
- grants from the FHIS (*Fondo Hondureño de Inversion Social)*,
- USAID/FHIS — Employment Generation Unit loan program,
- *Banco Municipal Autónomo* (BANMA) (lending — discontinued),
- Government of Honduras (lending — discontinued),
- direct loans from the Inter-American Development Bank, and
- preinvestment funds, including
    - *Fondo Hondureño de Preinversion* (FOHPREI), and
    - FUNDEMUN

The private sources of funding in use by municipalities in Honduras include

- commercial bank loans,
- municipal bonds,
- leasing, and
- privatization

Other sources of private funding common in many municipal finance systems, but not readily available in Honduras, include the following

- greater access to capital markets,
- short-term market financing,
- expanded bank financing,
- PROMUNI, and
- pooled financing vehicles or bond banks

Laws and regulations define municipal access to sources of financing The Honduran legal framework establishes three different paths for municipalities to access finance domestic borrowing, domestic bond issuance, and international debt The highest level of central government control is found in connection with international borrowing by municipalities Central government control over subnational external borrowing is very common in Latin America, and in most financial systems

The legal framework also influences the incentives for municipalities to enter into public-private partnerships for municipal service provision, but does not provide a consistent context in Honduras for carrying out these arrangements Some legal reform in this area may be called for

2 2 The Honduras Macroeconomy and Financial Market Conditions

Since the 1980s, economic conditions in Honduras have not significantly improved The difficult conditions have come about partially as a result of the implementation of a series of well-intentioned structural reform programs in the 1990s, which were meant to produce long-term benefits reduced inflation, increased savings, reduced public debt, and economic growth Yet high inflation and high interest rates for borrowers have been the norm in Honduras for the past decade

The prospects for continuing macroeconomic policy reform in Honduras are as yet unclear Decisions yet to be made by the new administration will have great influence on the feasibility of expanding the availability of financial resources for municipalities Establishing lower and less volatile inflation and interest rates, and creating a deeper capital market in which investors have confidence, are essential prerequisites to the ideas discussed in this assessment

In many countries, banks play an important role in municipal finance Honduras has a small banking sector, when measured by the amount of funds on deposit in banks relative to the GDP of the country Due partially to a lack of competition in the banking sector, the cost of borrowing from banks is high in Honduras The spread between deposit and borrowing rates in Honduras has recently ranged as high as 16%

The condition of the banking system does not invite great optimism over its role in helping build an expanded municipal finance system However, certain regulatory changes could bring positive results The Law of Financial Institutions, passed in October 1995 could improve conditions in the banking sector and in the financial sector generally over time, and reforms in monetary policy appear to bode well for the availability of funds in the banking system If municipalities were able to present information that demonstrated a good credit risk to financial institutions, they might find interested lenders

The state of the capital market affects the ability of municipalities to raise funds for municipal development Buyers of capital market instruments may be either institutional investors (pension funds, insurance companies, mutual funds, etc) or retail investors (individuals and other small holders) If liquid and well managed, institutional investors can contribute significantly to the availability of long-term funds in developed capital markets In Honduras, the state of the pension funds may represent an impediment to the development of an expanded capital market A number operate under a "pay as you go" approach to meeting pension obligations, and others have limited liquidity because they have invested directly in such projects as affordable housing The assets of others may not be liquid, as government bonds paying below-market interest rates have been given to them by government in lieu of required cash contributions

Numerous reforms are proposed for the pension funds that would contribute to their capitalization, including privatization and the development of capitalized interest (or defined contribution) accounts, which would be funded with proprietary funds of the pension fund contributors

The existence of a active treasury market in Honduras is good news for municipalities The presence of treasury instruments creates investor familiarity with government financial instruments, making the sale of municipal securities easier Treasury sales help establish a baseline interest rate that can be used to set interest rates from municipal securities, and, if treasury bonds are sold, some of the appropriate intermediary institutions will be in place for the municipal market as well

3 Adequacy of the Current System and Key Constraints

Unless additional resources are made available to municipalities in Honduras on a sustainable basis, it appears that there will be a widening shortfall in capital investment funds relative to that required by the municipal sector

The priority should be to address the most critical constraints on expanding the system (such as expanding available funds and improving the policy environment for borrowing) and on carrying out other activities that will contribute to the long-term sustainability of the overall system (such as improving municipal financial soundness)

The following is a summary of the characteristics of the Honduras municipal finance system today, organized according to the list of "essential elements" identified at the beginning of this Executive Summary

- **Creditworthiness** A small but growing number of municipalities are becoming creditworthy At the same time, even poor municipalities may have specific services that are "finance-able," even if their financial resources are generally limited The goal of improving creditworthiness should continue to be a cornerstone of development activities in the municipal sector

- **Information** Quality public information about municipal finances and data about the municipal sector is very limited, although some improvement measures are under way, such as the development of accounting standards for the municipal sector A strategy for improving information quality and quantity in the municipal sector may be needed Improving information can be a relatively low-cost intervention in a developing market

- **Technical assistance** A competent cadre of professionals exists and is in formation in Honduras Some municipalities hire consultants directly at full cost, but many receive assistance at a subsidized cost Lack of up-front funding for project development can limit municipalities' ability to hire needed assistance, no matter how plentiful it is Increased funding to sustainably finance technical assistance to municipalities appears to be needed

- **Expanded funding, appropriately allocated** This is one of the most challenging aspects of the Honduran situation Funds for municipal investment are not adequate, measures must be taken to increase the supply of funds available, from both private and public sources An adequately funded public or public-private entity that does business like the private sector appears to be needed to fill the gap between the existing mechanisms and whatever additional financing the private sector will provide This should be accompanied by development of a credit rating or credit scoring system for municipalities that would support an approach under which financial resources are allocated on the basis of credit quality, rather than need

- **Innovation** The low level of involvement by the private sector in providing funds to municipalities is one of the most fundamental weaknesses of the current system The financial sector is constrained by the macroeconomy in Honduras and by the lack of information available to them about this potential "market " Financial institutions that have been willing to lend to municipalities should be encouraged, and programs such as PROMUNI that help share the risk with financial institutions should be considered

- **Legal/regulatory support** Honduran law is generally supportive of municipal finance, although there are revisions that may be needed, in both the municipal and financial sectors Municipal sector players may need to become involved in a broader policy reform agenda, in such areas as macroeconomic policy, which may appear to be outside of the normal range of municipal concerns

- **Policy framework** No comprehensive framework is in place in Honduras, policies that affect the ability of the municipal sector to finance are made on something of an *ad hoc* basis The concept of the municipal finance system **as a system** whose shortcomings should be addressed systematically is not widespread, but should be encouraged As a first step, some general goals and indicators for municipal finance development might be established and used as a basis for reporting progress

- **Public-private dialogue** There does not appear to be any forum in Honduras for a public-private dialogue on municipal finance at the present time As a consequence, the perspectives of the private sector are not well known or integrated into the thinking about the development of the municipal finance market Similarly, the financial sector is not now committed to meeting the needs of municipalities, and the municipalities do not know what it will take for them to become interested Creating a forum could be the first step in facilitating this process

Part III Action Plan — Toward an Expanded Municipal Finance System

Listed below are broad strategies for carrying out the activities recommended in this assessment A wide range of options in each area are discussed in the report These options demonstrate that in each area improvements can be made, sometimes by means of very small, but important, steps

Encourage Continuing Improvements in Municipal Financial Condition and Communicate Results

Continuing efforts to improve the financial condition of municipalities, and to share the results, are imperative for the development of an expanded system The number of viable municipalities needs to be expanded as well Developing indicators for defining and measuring progress in this area should be given full support Coordination among various entities providing financial support for municipal development is also encouraged

Assist Efforts to Expand Financial and Other Information about Municipalities Usable by Creditors and Others

Lack of information can result in the failure of otherwise viable financial markets Often important results have been seen from minimal intervention on this element Efforts should be expanded to improve the information necessary for financial system functioning, including investment plans, financial performance reports, accounting standards and audits, credit rating system, and communication of lessons learned

Encourage Continuing Development of the Market for Technical Assistance

Encouraging innovation and access to technical assistance is a key element of financial system development In particular, efforts should continue to lower the costs and time requirements of the project development process, thereby helping improve the affordability of the resulting investments

Transparent Strategy for Expansion and Best Use of Available Concessionary Funding

The private sector is likely to expand its financing activities with local governments in Honduras only with support from public or concessionary sources Institutions in the public sector involved in municipal finance should develop ways to provide the "credit enhancement" or "risk management" sought by the private sector, staying away from using guarantees, which are highly disruptive of a developing market, whenever possible

Support Innovation in the Raising of Investment Funds and Gain Additional Transactions Experience

In spite of the limitations presented by the current system, it is important to continue to attempt new types of transactions by municipal borrowers, assuming they can be carried out at costs affordable to municipalities Pilot final transactions and privatization projects educate municipal officials and bring to light the limitations of the policy framework and create pressure to resolve constraints New transactions should be continuously tried

Innovation should also be pursued at the institutional level Options for a new institution that can draw financial resources into the municipal finance system should be explored A wide variety of new intermediary models are being developed around the world for municipal infrastructure finance Important goals include maximum initial participation of the private sector in such an entity and increased private participation over time

Support Efforts to Improve and Enforce the Legal/Regulatory Framework

While some improvements in the legal/regulatory framework may be called for, so is implementing beneficial elements of the existing legal framework Issues to be addressed include constraints on municipal revenue raising and unnecessary restrictions on municipal borrowing and privatization

Promote Development of an Integrated Municipal Finance Framework

A framework for organizing developmental activities related to municipal finance is needed to guide future reform and development This framework should represent as much as possible the consensus of those institutions with an interest in the municipal finance system Substantive central government involvement in the development of this framework should be considered a fundamental requirement

Create a Public-Private Forum for Finance Policy Dialogue

A forum can help promote the concept of municipal finance as a system with many different players and elements and can help create a focal point for the dialogue that can lead to articulation of a municipal finance framework It can also ensure that experience is shared as it is gained The participants should be all those with an interest in the development of the system, including the Honduran public sector (central and municipal government, etc) and private sector (banks, consultants, investors, etc) and donors The public-private forum could provide technical leadership, political leadership, and political support to the process of developing a framework, as well as an administrative and/or oversight function

Develop a Monitoring Mechanism for Municipal Finance System

Honduras needs a monitoring mechanism ("report card") to measure progress on municipal finance system development Indicators help track progress and also actually influence where progress is made The initial report card could identify the critical elements and related indicators and set goals A baseline grading of the various elements should also be done Subsequent annual reports could track progress, update the grades, and set new goals, as appropriate Elements might include the number and size of loans, characteristics of municipal borrowers, and the actions of institutions

Part I Introduction of the Assessment

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1 The Purpose of the Assessment

The Office of Municipal Development and Democratic Initiatives (MDDI) in the Honduras Mission of the United States Agency for International Development (USAID) requested assistance that would enable the Mission to provide direction to the Government of Honduras (GOH), municipalities, and the financial sector in Honduras in the development of a more sustainable system of municipal finance The investigation would address both public and private sources for municipal infrastructure investment, and focus on basic services, i e , water, sewerage, and solid waste management The initial component of this assistance was an assessment of the current system for municipal finance in Honduras This report is the result of that assessment

The development of a "framework for municipal finance" has been proposed as a focal point for the creation of a more sustainable municipal finance system in Honduras When fully developed, a framework should reflect the consensus of all players on how a more expanded system is to come about and would provide guidance to them on the process to follow to develop such a framework

A major purpose of the present assessment is begin to build a base of knowledge upon which the framework can be constructed It provides a description of the context for municipal finance (Part II, 1 the Municipal Sector and 2 the Current Financing System) and identifies key constraints in the current municipal finance system that will need to be addressed if municipalities are to have sustainable, long-term financing sources available to them in future years (Part II, 1 the Municipal Sector, and 3 Adequacy of the Current System and Key Constraints) This report also includes a proposed process to follow to arrive at the finance framework and recommendations for appropriate financing mechanisms, in the short to medium term (Part III Action Plan — Toward an Expanded Municipal Finance System and Annex 4 Potential New or Modified Roles for USAID/Honduras)

2 Defining the Municipal Finance System

Exhibit 1 (page 12) below is a graphic representation of the elements of a well-functioning municipal finance system and some of the most important influences on it It has served as the frame of reference for this assessment and is described in detail below The objective in municipal finance system development is to create a financing system that provides both public and private financial resources on an ongoing basis, so that a) municipalities have their financing needs met, especially for essential services, and b) the services that result are affordable and available to the maximum number of people These are complex objectives not quickly accomplished

Long-term debt financing plays a central role in all mature municipal finance systems This may be in the form of bonds or loans Many capital investments related to municipal services involve high up-front costs in investments that generate a stream of financial and economic benefits over time This circumstance makes long-term financing appropriate, because revenues can be raised over time to pay off debt service payments from the borrowing A shortage of adequate credit or other long-term funding leads to underinvestment in municipal infrastructure since it leaves "pay-as-you-go" (short-term) financing or grants as the only alternatives Public sector and concessionary sources provide some long-term funding, but financial markets are the most sustainable source of adequate financing Therefore, one of the critical assumptions underlying this analysis is that market-based sources of financing must be tapped, at least for the most creditworthy municipalities, if the overall municipal finance system is to expand sufficiently to serve all the investment demands emerging in Honduras on a sustainable basis

A related assumption is that the primary focus should be on the development of a local currency financing system, rather than a system that raises funds in dollars or other foreign currencies Even in fairly developed financial systems, external debt is too costly (or too risky) for local governments Insurance is needed to guard against fluctuations in the value of foreign currency repayments, and once the cost of this foreign exchange "coverage" is factored in, foreign funds are generally found to be more expensive than funds borrowed locally (The only exception may be local governments who receive foreign-denominated income, such as port cities)

Municipal finance system development generally has two components

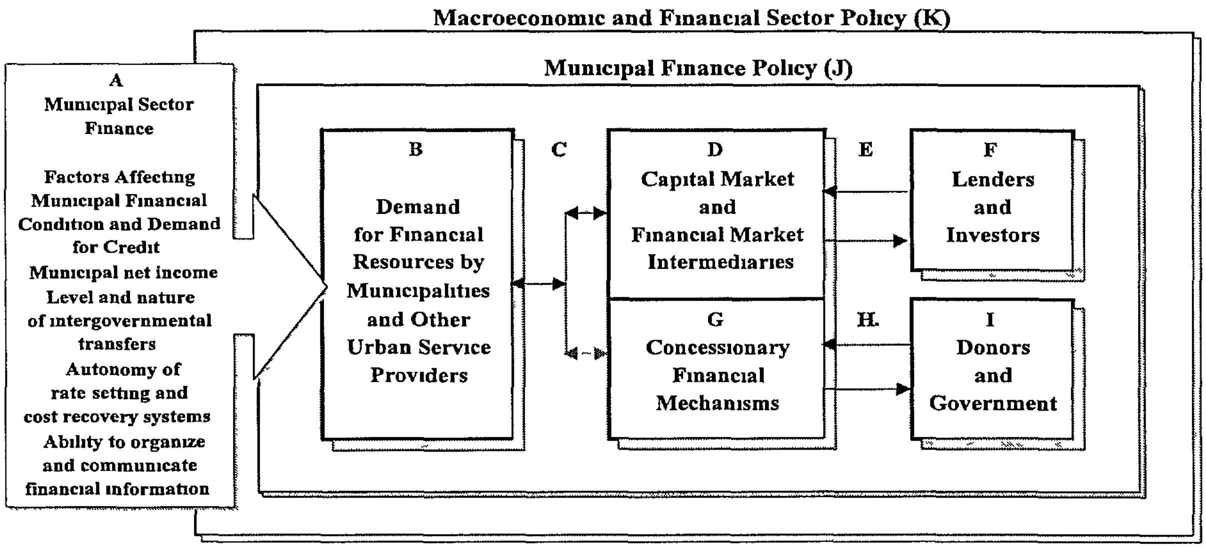
- Municipal sector finance — strengthening the tax base, financial management, and financial condition or creditworthiness of local governments, and
- Municipal finance systems — improving the system used by local governments to raise the financial resources necessary to carry out essential activities and services, and expanding the levels of financial resources within that system

In the case of municipal sector finance, interventions generally include technical assistance to municipalities and policy reform to improve the policy environment that affects municipal finance and borrowing For municipal finance systems, development activities include policy reform, institutional reform and development, and development of rational schemes for increasing and allocating resources

These two activities are equally important and are interdependent Unless at least some municipalities become creditworthy, all municipalities will need to rely on the same pool of grants (which are in short supply) even if credit mechanisms are created But the same time, unless municipalities know they will be rewarded with access to more financial resources, the motivation to improve their financial condition is lessened The process of municipal sector financial development is well under way in Honduras, the emphasis of this report is on improvements that are needed to improve the financing system, although certain municipal sector issues are also addressed

Exhibit 1 represents a municipal finance system that provides both commercial and non-commercial funding sources to finance projects The elements of the system, and the issues addressed during the municipal finance system development process, include the following

Exhibit 1
Elements of Municipal Finance System Development



- **Municipal Demand for Resources** (B) This is the collective demand for municipal finance for investment projects by local governments and their instrumentalities This demand is strengthened through municipal development activities that improve creditworthiness and help municipalities better define and forecast their investment needs Participatory processes that affirm public support for projects also help strengthen municipal demand
- **Factors Affecting Municipal Financial Capacity** (A) include those things that affect municipal capacity to raise financial resources and repay them when required Four key factors are the level and predictability of municipal net income, the level and nature of central government transfers, the autonomy of the municipal rate setting and cost recovery process, and the ability of municipalities to organize and communicate basic financial information
- During the **Project Development Process** (C) projects are prepared and structured, funding sources are identified, and funds are committed to projects (and later repaid, if borrowed) This structuring and borrowing process, especially when market credit is involved, can be difficult and time consuming for local governments Many central governments and development finance institutions provide technical assistance to facilitate this process, with varying degrees of success Ideally, municipalities should have a range of expertise available to them at reasonable cost

The diagram shows municipalities simultaneously accessing both market-based and concessionary funding sources (D and G) in order to fund projects This reflects the reality of most municipal finance systems—co-financing between market and non-market-based funders is the norm The non-market funding includes "equity" provided to the project by the local government from its internal sources, as well as grants and concessionary loans Market funds are those borrowed from financial institutions The process of bringing recipients and providers of funding together is referred to as "intermediation "

- **Financial Market Transactions** (D, E and F) take place when institutions, such as investment banks, make a match between a borrower and willing lenders, using municipal loans, bonds or other investment "vehicles " This match-making process may involve other organizations such as those providing information (credit rating agencies), those managing the legal aspects (bond counsel) and those lowering the risk for lenders (guarantors or other credit enhancers) Building a sustainable market finance component of the municipal finance system means figuring out what must be done to make investors choose to invest in a municipal security rather than in some alternative It may also mean taking steps to interest financial institutions in playing this "go-between" role for the municipal sector Doing so often includes improving the quality of information provided from each side of the transaction

  Historically in many countries, investors have received guarantees on local government loans and bonds This may include currency guarantees on foreign borrowings These are becoming increasingly rare, due to fiscal constraints at the national level, but the expectations of investors remain Designing other forms of "credit enhancement" for lenders is therefore important
- **Concessionary Funding Transactions** (G, H and I) parallels that of financial market intermediation in the sense that it entails specific institutions (such as development banks) that have their own funding sources, lending procedures, and information requirements In Honduras, as elsewhere, much of this funding has been provided to projects according to non-market considerations, such as poverty rates, population levels, or political influence But, in many emerging municipal finance systems, some portion of the available concessionary funding is being used to help local governments raise private financing, by helping to mitigate risk or lowering the size of the loan

A broad range of policy decisions at the national level affect whether market-rate financing is available to municipalities, especially municipal finance policy (J) and macroeconomic and financial sector policy (K) These policies affect the willingness of financial institutions to work with local governments and the preferences of local governments for raising funds For instance, if municipalities can't guarantee adequate cost recovery due to restrictions on their rate-setting powers, investors will be nervous that they may not get repaid Or when securities are difficult to sell due to a lack of securities market regulation, that will limit municipal capacity to raise market capital

These policies may appear to be beyond the influence of municipal players However, it may be necessary for the municipal representatives to become conversant in these policy issues if they are going to advocate for the changes that are needed to expand municipal financing options

- **Municipal finance policy** (J) is used here to refer to policies that influence the ability of local governments to plan investments, raise revenues, manage their finances, acquire funds for investment projects and relate to the financial sector A municipal finance policy is affected by laws (municipal law, capital markets law, privatization law, etc), but often consists mostly of policy statements and agreements among the levels of government A comprehensive municipal finance policy would provide direction and transparency, and identify the roles of all the players (central government, the municipal sector, and the private sector) in the overall municipal finance system

Few countries have in place a municipal finance policy as comprehensive and transparent as that described above (South Africa and the Philippines are attempting to do so), more common is a patchwork of policy statements and laws that guide municipal finance and may be contradictory and out of date This is especially true where significant fiscal decentralization is still taking place

- **Macroeconomic and financial sector policies** (K) also exert enormous influence on the ability of markets to develop and the municipal sector to borrow Financial sector policies affect the competitiveness of the financial sector, the financing options they offer to the market, and the relationships among financial institutions and between these institutions and the central government Macroeconomic policies affect the flows of capital into and out of the country, market liquidity, and the incentives under which investors and savers interact It influences inflation rates, exchange rates, interest rates and other terms of financial instruments offered, and the cost of foreign exchange coverage Both affect the economic viability of municipal market financing Macroeconomic policy may affect the level of resources available from transfers and other government sources, as well

A final essential element of municipal finance systems that is not explicitly represented, but deserves mention, is information

- **Information** is the "glue" that holds financing systems together, but is often in short supply in developing financial systems Without adequate information, even viable investments may never be made Information is used to show the financial status of municipalities and identify trends, provide comparability and help set standards, and communicate financing options and share experience Examples include regular financial statements based on accounting standards, service demand and financial forecasts, disclosure guidelines for financial transactions, credit ratings, performance standards and performance reports

3 The Basic System Requirements

The discussion above can be summarized into a list of basic requirements for expanding the municipal finance system and making it sustainable These are listed here and later compared to conditions that exist today in Honduras and used to help identify potential system development strategies and indicators to measure progress

- **Creditworthiness** Incentives exist to move local governments in the direction of greater creditworthiness, and the strongest municipalities are perceived as good credit risks
- **Information** A range of timely financial and other information about municipalities is available to creditors and others
- **Technical assistance** Municipalities have access to fairly priced technical assistance on municipal finance matters
- **Expanded funding, appropriately allocated** A coordinated, transparent strategy is in place for best use of concessionary funding Municipalities who work to improve their creditworthiness are rewarded with expanded funding

- **Innovation** A range of financing sources are available A variety of transactions and financial structures are in use and are widely understood by local governments
- **Legal/regulatory support** The legal and regulatory systems for municipalities, the financial sector and the macroeconomy support municipal finance
- **Policy framework** A municipal finance policy or framework guides implementation
- **Public-private dialogue** A forum exists that encourages a public-private dialogue on municipal finance and invites private sector involvement in the development process

Part II: Findings of the Assessment

The assessment of the Municipal Finance System in Honduras is presented below in three sections Section 1 focuses on the municipal sector — its demand for revenues and capacity to access and manage such resources (Boxes A and B in Exhibit 1) Section 2 presents the municipal finance system — the array of resources available to municipalities and the efficiency of the current allocation (Boxes C-K in Exhibit 1) Section 3 summarizes key constraints in both municipal sector finance and the municipal finance system, with emphasis on the latter

1 The Municipal Sector

This section discusses the municipal demand for investment resources, the factors affecting municipal capacity to access those resources, and the organizations that strengthen municipal sector capacity

1 1 Municipal Demand for Resources

The capital investment requirements of municipalities must be satisfied either through municipal sector finance (local sources) or else through the municipal finance system (external sources) Quality information on municipal investment requirements does not exist in Honduras Multi-year capital investment programs would be a potentially valuable source of information, however, only a small number of Honduras's 289 municipalities are understood to prepare such programs Even if all municipalities did prepare such programs, however, those documents themselves might not reflect total investment requirements If municipal access to financing was limited, for example, such programs might reflect sub-optimal levels of investment

Despite the lack of quality information, some inferences can be drawn about municipal investment requirements, in part via a comparative analysis between countries Factors that influence municipal demand for resources are discussed below Based on these factors, a rough estimate of municipal investment requirements is then presented in Section II 3

1 1 1 Levels of Poverty and Urbanization

Poverty levels affect investment requirements as well as strategies for financing capital investment Poor people will demand essential services, but will often not be willing or able to pay for high service standards Poverty will therefore exert downward pressure on investment requirements Even when minimal services are provided, high levels of poverty may make it difficult to recover the costs for municipal service provision from the users themselves

Honduras is the third-poorest country in the Western Hemisphere and, after Nicaragua, the second-poorest in Central America Annual gross domestic product (GDP) per capita is estimated at US$813 for 1997 Honduras's per capita GDP is about one-half the average for Central America and about one-fourth the average for all of Latin America Honduras's economy is not keeping pace with the region between 1990 and 1996, the average annual GDP growth rate for Honduras was 3 4%, compared to a Central American average of 4 0% [1] These conditions may make recovering costs from investments in urban services more difficult

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[1] Inter-American Development Bank *1997 Report* and USAID/Honduras, 1997

Rapid urban growth rates fuel the need for investment in municipal infrastructure Urbanization has been occurring at a faster rate in Honduras than in most other countries in Central America Between 1990 and 1996, the annual urban growth rate was 4 9% in Honduras versus 3 9% in the rest of the region (Honduras's total level of urbanization — 48 6% of total population in 1996 — was, however, typical for Central American countries) This rapid urban growth rate, attributable both to natural increase and in-migration from rural areas, translates into greater demands for capital investment

1 1 2 Municipal Responsibilities for Service Provision

The set of services that municipalities are legally responsible for providing has a bearing on their financial resource requirements — the more responsibilities, the greater the financing requirements Table 1 1 below compares service responsibilities in Honduras versus other countries in Central America

Table 1 1[2]
Responsibilities for Providing Local Services

Local Service	Municipal Responsibility*					
	Honduras			Other Countries in Central America**		
	Municipal	Shared	National	Municipal	Shared	National
Public Services						
Solid waste	•			4	1	0
Market	•			5	0	0
Cemetery	•			5	0	0
Streets and sidewalks	•			4	1	0
Secondary roads		•		0	4	1
Water		•		1	2	2
Wastewater		•		1	2	2
Electric energy			•	0	1	4
Transit police			•	0	1	4
Urban transport			•	1	2	2
Social Services						
Education infrastructure		•		0	4	1
Education administration			•	0	1	4

NOTES
* "Municipal" refers to an exclusively municipal responsibility
Shared means responsibility shared is between national and municipal government
National means is exclusive responsibility of municipal government
** Data refer to number of countries that correspond to each category Countries are Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama

[2] USAID/RUDO/CA, 1997

Table 1 1 shows that the Honduran profile of municipal responsibilities is fairly typical for Central America Municipalities have more responsibilities in some countries (e g , exclusive responsibility for water/wastewater services in Guatemala) and fewer responsibilities in others (e g , Panama), but Honduras is about average These levels of administrative decentralization mean that, all else being equal, per capital municipal revenue requirements in Honduras should be roughly comparable to other countries in Central America Despite two generations of reform that has favored decentralization, Central America — and Latin America in general — remains relatively centralized compared to most industrialized nations

Determining municipal investment requirements is particularly difficult where service responsibilities are shared with the central government and/or are not clearly defined This is the case with aspects of water and wastewater service provision The Municipal Law (1991, as amended) charges municipalities with constructing, operating, and maintaining systems for potable water distribution and sewerage, however, in reality, these responsibilities are shared For water distribution, municipalities are estimated to administer 65% of total connections, while the National Autonomous Service for Water and Wastewater (*Servicio Autonomo Nacional de Agua y Alcantarillado* [SANAA]) supplies 35% of the connections Virtually all wastewater services are managed by municipalities, with the exception of Tegucigalpa, which is administered by SANAA This lack of consistency adds to the complexity of determining municipal investment requirements and assessing the adequacy of the municipal finance system [3]

1 1 3 Adequacy of Service Provision

The lower the current levels of service provision, generally the greater the need for capital investment to bring service conditions up to acceptable levels Comparative data exist for water and wastewater services, they may reflect levels for other municipal services as well Thirty percent of Hondurans lack access to safe water, and 34% lack access to sanitation These levels are roughly similar to the rest of Central America, where 34% lack access to potable water and 24% lack access to sanitation services These levels of coverage are, however, greatly inferior to high-income countries, where nearly everyone enjoys access to drinkable water and 93% to sanitation

Provision of networked water and wastewater services in urban areas has stagnated over the last 20 years Even for those with nominal access to those services, the quality of service may vary greatly, particularly in marginal barrios Piped water may flow intermittently, at low levels of pressure and of inferior quality Latrines have come to play an increasingly important role in providing sanitation services in 1993, one out of every two urban households relied on latrines instead of sewerage networks [4] Increasing reliance on these sorts of non-network strategies for providing both potable water and sanitation services may suggest a chronic shortfall in the financing of these key municipal services

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[3] Walker, Ian et al , *Regulation Organization and Incentives The Political Economy of Potable Water Services Case Study Honduras*, August 1997

[4] *Ibid* , World Bank, *World Development Report 1996*, and PADCO Inc 1997

In summary, Honduran municipalities have significant demands for resources to finance capital investment they face the challenge of improving the provision of important basic services in the face of high levels of poverty and rapid rates of urbanization Capacity to meet those challenges is discussed below

1 2 Municipal Capacity

Capacity refers to the ability of municipalities to mobilize and manage resources so as to fulfill their obligations It reflects not only institutional capacity, but also the set of revenue sources assigned to municipalities, and their ability to access those resources After those revenues are mobilized, capacity is finally reflected in municipalities' ability to focus significant amounts of those resources on capital investment These topics are explored below

1 2 1 Institutional Capacity

In the early 1990s, the Presidential Commission of Modernizing the State (*Comision Presidencial de Modernizacion del Estado*) estimated the level of development of Honduras's 289 municipalities Municipalities' composite scores, based on a wide range of factors (including health, basic sanitation, housing, income, etc) were as follows

Table 1 2[5]
Municipalities by Category of Development, 1991

#	Category	Municipalities		Population
		Number	% of Total	
D	Stagnant	235	81 3	2,055,021
C	Slowly Developing	42	14 5	1,262,343
B	Developing	9	3 1	481,792
A	Developed	3	1 0	1,159,188
--	Total	289	100 0	4,958,344

According to this classification, 96% of all municipalities were considered "stagnant" or "slowly developing " These municipalities represented 70% of the national population and were generally smaller (less than 20,000 total population), rural (less than 40% urban population), and lacking in services (less than 50% of population with access to basic services) These municipalities can be expected to have difficulty mobilizing the resources necessary to provide urban services

The 4% of municipal governments considered "developed" or "developing" in 1991 had organized themselves so as to carry out a range of functions (treasury, cadastre, public services, planning, accounting, etc) and were staffed by at least 30 employees Key procedures and documents — development plans, investment plans, inventory of municipal property, program budgets, etc — were reportedly in place Procedures for public participation (town meetings, etc) were reportedly in use These more developed municipalities were generally located in

[5] Presidencia de la Republica Comision Presidencial de Modernizacion del Estado, *Cuadernos de Descentralizacion Categorizacion Municipal*, 199_

Regions I or II and in port or tourist areas and/or were department heads (*cabeceras departamentales*) These municipalities could be expected to have higher levels of capacity in mobilizing local revenues These municipalities may generally represent the targets for market-based financing (Boxes D, E, and F in Exhibit 1), while the needs of other municipalities would more likely be met by concessionary funding transactions (Boxes G, H, and I), in at least the short to medium term

More recent assessments of municipal capacity are not available, however, the number of "developed" and "developing" municipalities has undoubtedly increased since 1991 This is due to implementation of the new, progressive Municipal Law, as well as the effects of the USAID Municipal Development Programme (MDP) and other initiatives The 30 municipalities supported by the MDP, and Tegucigalpa, would now most likely be classified as developed or developing

While these 30 municipalities could be considered as "developed" or "developing," a recent investigation of financial management in Tegucigalpa and San Pedro Sula showed that room for improvement still exists Systems in place in those cities do not fully support modern practices in budgeting and financial management, including the treatment of individual municipal services as cost centers (Those cities have, however, made significant recent improvements in their billing and collection systems) One can generally predict shortcomings in financial management in even the largest Honduran municipalities

1 2 2 Municipal Revenues

Municipal revenues are a function of the revenue sources assigned to municipalities, as well as such factors as local officials' ability and commitment to access those revenues and the underlying tax base itself

Total municipal income in Honduras stood at US$62 8 million in 1992 This represented about 2% of GDP As shown in Table 1 3, in Central America only Nicaraguan municipalities accounted for a higher percentage of GDP (3 1%), in all other countries in the region, municipalities receive less than 1% of GDP (Because GDP is relatively low in Honduras, however, municipalities in other countries, such as Guatemala, may receive more resources in absolute terms) Despite these relatively high levels, the pressure of municipal taxes is not excessive in Honduras Table 1 3 shows that municipal tax pressure (measuring municipal tax income as a percent of GDP) is substantially higher in Nicaragua, where citizens are generally poorer than in Honduras All else being equal, this suggests that municipal tax collections could increase in Honduras without excessively burdening citizens

Table 1 3[6]
Indicators of Municipal Income

Indicator	Honduras	Costa Rica	El Salvador	Guatemala	Nicaragua	Panama
GDP (1994 million US$)	**3,333**	8 281	8 116	12 919	1 833	6 975
Municipal Income as % of GDP	**2 1%**	0 8%	0 4%	0 9%	3 1%	0 7%
Municipal Tax Pressure (Municipal tax income as % of GDP)	0 7%	0 4%	0 2%	0 2%	2 0%	0 5%

Data also show that Honduran municipalities enjoy relatively high levels of fiscal decentralization for the region Honduran municipalities' share of total government spending (12 3%) exceeded levels in Costa Rica, Panama, Nicaragua, and El Salvador (average 4 2%), and even edged levels for Guatemala (10 3%), with its sizable intergovernmental revenue transfer (see Table 1 4) This strength can be largely attributed to passage of the progressive Municipal Law in 1991 and subsequent municipal development efforts by USAID and others

Table 1 4[7]
Subnational as a Percent of Total Government Spending, 1995

	Honduras	Central America	Latin America	Industrial Economies
Ratio of Subnational to Total Government Spending	12 3%	6 6%	14 6%	34 9%

Despite its relative fiscal strength in the region, the municipal sector in Honduras is relatively weak compared to industrial countries As shown in Table 1 4, subnational governments in Honduras accounted for only a third as much of government spending as did their counterparts in industrial economies Honduras's levels were, however, typical for Latin American countries

The Honduran municipal sector obtains its resources from a diverse set of revenue sources, those sources are discussed below

Local vs External Sources of Municipal Revenue

Too much dependence on intergovernmental revenue transfers may discourage the mobilization of resources generated locally by the urban economy The Honduran municipal sector is not excessively reliant on external sources of revenue In Honduras, a full 59 4% of total revenues stemmed from local taxes, user charges, and a betterment levy (*contribución por mejoras*), with an intergovernmental transfer (an external source) contributing to the remainder This reflects a better balance of local versus external sources than, for example, Guatemalan municipalities, which some consider overly dependent on intergovernmental transfers (see Table 1 5) (For a

[6] USAID/RUDO/CA 1997 and the World Bank, *World Development Report 1996*

[7] Inter-American Development Bank *1997 Report*, p 157 and PADCO, Inc 1997 By definition the sources of spending should include both local sources and external sources, such as intergovernmental transfers

discussion of whether Honduran municipalities receive insufficient resources from the transfer, see below)

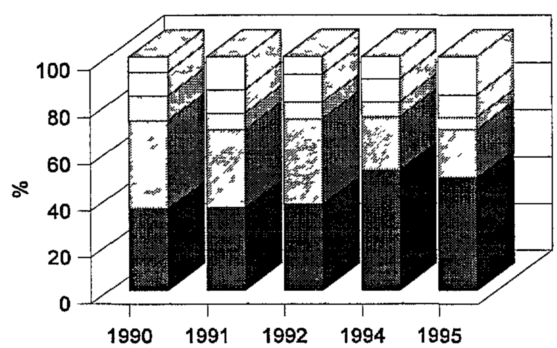
Table 1 5[8]
Relative Importance of Intergovernmental Transfers in Central America
Mid-1990s

	Nicaragua	Panama	Honduras	Costa Rica	El Salvador	Guatemala
Ratio of Own-Source Revenues/Transfer	93/7	92/8	**85/15**	82/18	65/35	30/70

Local Taxes and the Betterment Levy

The relative contributions of the principle local taxes and the betterment levy are shown in Figure 1 1 These local revenue sources are discussed below, in terms of such factors as their ability to generate revenue, buoyancy, economic efficiency, fairness (equity), administrative feasibility, and political palatability

Figure 1 1[9]
Taxes and Betterment Levy
Municipal Sector (1990-92 and 1994-95)



Tax on Industry, Commerce, and Services In terms of revenue generation, this tax (the *impuesto sobre industrias, comercios y servicios*) is currently the most important tax in the municipal finance system It is applied on income generated by the production, sales, and provision of services The importance of this tax has risen in recent years until, in 1995, it represented almost half (48 7%) of all income generated by the sources shown in Figure 1 1,

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[8] Perez, M , Jose Antonio *Sistemas Tributarios de los Gobiernos Locales en el Istmo Centroamericano* USAID/RUDO/CA 1997

[9] *Ibid*

it is thus buoyant The tax is administrable, particularly by larger municipalities that receive training The Municipal Development Foundation (*Fundacion de Desarrollo Municipal* [FUNDEMUN]) has helped some larger municipalities double their receipts from this tax in only one year, by enumerating the tax base and otherwise improving administration This tax is most important in the more prosperous municipalities, while its use is limited in poorer locales

Income generated by the export of non-traditional exports has been granted an open-ended exemption from this tax In the long term such a policy may distort economic decision making and may erode cities' abilities to support economic development Similarly, the law applies a lower tax rate to the production and sale of products subject to price controls, a policy that could provoke allocative inefficiencies

Real Property Tax The real property tax (*impuesto sobre bienes inmuebles*) was the single most important municipal tax in 1990 Its importance has declined so that in 1995 it represented only about a fifth (20 6%) of income generated by taxes and the betterment levy Property taxes can be structured so as to serve as the cornerstone for municipal income In Honduras, however, Decree 124-95 and other actions have undercut this tax's buoyancy and revenue-generating potential by broadening exemptions, lowering the tax incidence ceiling, and requiring municipal officials to reach consensus with "various economic and social sectors" on how to apply the tax These actions have rendered the tax almost voluntary

The property tax is based on the assessed value of the land and improvements Rates are differentiated between urban and rural properties, with rural properties paying less As is fairly typical in developing countries, property value is assessed only once every five years This arrangement, while understandable due to the effort involved, contributes to the undervaluing of property and makes it difficult for revenues to keep pace with expenditure requirements One practical solution applied in some countries, progressively increasing the tax incidence during off-years and then readjusting the rates following reassessment, is not practiced in Honduras

Municipalities are responsible for virtually all aspects of property tax administration Administering such a system is relatively challenging, particularly for Honduras's many small municipalities Municipalities, assisted by USAID and FUNDEMUN to expand and update municipal cadastres, have, however, in some cases doubled the revenue streams from this tax In addition to its importance in larger cities, the real property tax also has great income potential in rural municipalities with high land values, such as in the coffee-growing zone

Personal Tax The personal tax (*impuesto personal o vecinal*) is applied to annual personal income As such, it has been criticized as duplicating the national income tax (*impuesto sobre la renta*) The municipal tax produced only 5 1% of all income from taxes and the betterment levy in 1995 (Figure 1 1) It is most heavily applied in Tegucigalpa

Other Taxes Finally, municipalities also have the right to collect several additional taxes of lesser importance The tax on the use of natural resources (*impuesto por explotación de recursos*) has not been fully exploited to date The surcharge on animals slaughtered in the municipality (*impuesto pecuario*) and the billiards and controlled substances tax (*impuesto a billares y* *productos controlados*) can be considered as nuisance taxes, and are of lesser importance in most municipalities

Betterment Levy As shown in Figure 1 1, the betterment levy (*contribucion por mejoras*) has yielded substantial levels of revenue for the municipal sector (9 5% of revenues shown in 1995) This fee is of particular importance in the context of municipal finance, given that the law requires that revenues generated by this fee be used exclusively to finance capital investment Some cities, such as Bogota, Colombia, have used similar development charges as a major source of financing for their capital investment programs Such levies are generally considered administrable and equitable, since the charge is applied to properties that benefit from a specific improvement

To date, the betterment levy has not been fully exploited in Honduras The law authorizes its levying against the owners of properties and others who stand to benefit directly from specific public works Moreover, the law authorizes use of this levy for a broad spectrum of projects — construction and paving of urban streets, electrical systems, telephone networks, provision of water, wastewater, and environmental services, and "other public works that will benefit the community " However, interviews suggest that, with a few exceptions, the betterment fee has been applied only for street paving and construction projects FUNDEMUN representatives speculated that municipal officials may be reluctant to attempt to collect this fee from poorer communities receiving basic services, whereas street-paving projects tend to benefit households that are better able to pay In a number of instances, the betterment levy has helped municipalities service loans FUNDEMUN, however, reports little demand from municipalities for training and technical assistance in use of this financing mechanism

User Charges

Achieving full cost recovery for municipal services involves capturing the marginal costs (both current and capital costs) associated with service provision Under the "user pays" principle, consumers are generally expected to shoulder these costs via user charges Realizing full cost recovery is an important policy goal for several reasons Some revenues generated under cost recovery conditions can be directly used to finance capital improvements Cost recovery likewise increases creditworthiness potential lenders will be more willing to lend to service providers who are able to mobilize revenues that can be used to retire debt

Self-financing revenues (service charges and the betterment levy) represented a relatively low percentage of locally generated revenues Local taxes thus assumed increased importance in the municipal finance system This condition can be attributed in part to central government involvement in providing certain urban services (particularly in Tegucigalpa) It may also indicate that user fees are underexploited and that greater attention to cost recovery for services would yield substantial returns

Information available regarding cost recovery for potable water services serves as a case study for cost recovery for municipal services in general Water service providers in Honduras are generally falling far short of achieving full cost recovery This is generally true of both SANAA and (with a few exceptions) municipal service providers (see Table 1 6) For 16 local systems analyzed, estimated losses averaged L 140 per connection per year for municipal systems and L 110/connection/year for SANAA systems If those levels were typical, in 1994 municipalities (with about 260,000 connections nationwide) would have lost about US$4 4 million in foregone revenue from water and wastewater services, SANAA (with about 140,000 connections) would have lost about US$1 8 million Those US$6 2 million in annual lost revenues could have been reinvested in urban infrastructure

Table 1 6[10]
Cost Recovery Indicators for Water Service Provision
A Survey of 16 Systems,* 1994

Indicator	Municipal Average	SANAA Average
Income per connection (LPS /yr)	L 103	L 107
Total expenditure on water and sewerage per water connection (LPS /yr)	L 252	L 225
Profit (Loss) per connection (LPS /yr)**	(L 140)	(L 110)

* Averages are for nine municipal systems and seven SANAA systems, respectively
** Income minus total expenditure Average profit may not exactly equal the sum of other averages due to data availability and different methods for calculating averages

A series of reasons accounts for this general lack of cost recovery, including a lack of transparency in the levels of subsidies and a lack of political will to raise tariff levels Despite the generally poor average results shown in Table 1 6, one notes that about one-quarter of the municipalities for which data were available showed net profits rather than losses for 1994 two municipal systems (Ocotepeque and Tocoa) and two SANAA systems (Comayagua and Intibuca) This finding offers some hope for the achievement of cost recovery and sustainable service provision despite the structural problems suggested above

Private or nongovernmental service provision may, however, offer the best hope for achieving full cost recovery This assertion is suggested by the results of one willingness-to-pay study conducted in the marginal barrios of Tegucigalpa Consumers were willing to pay substantially more for water service provided by barrio committees (*patronatos*) (L 44 8/month) and water boards (*juntas de agua*) (L 36 6/month) than they were for water provided by either the municipality (L 21 5/month) or SANAA (L 18 7/month)

A potential threat to cost recovery is the existence of the National Commission for Public Services (*Comision Nacional Supervisora de Servicios Públicos* [CNSSP]), with nominal responsibility for the economic regulation of public service tariffs This responsibility conflicts with

[10] Walker, Ian, et al *Regulation Organization and Incentives The Political Economy of Potable Water Services Case Study Honduras*, August 1997 The following conclusions rely heavily on that document

the right of municipalities to set their own tariffs While to date the Commission has not interceded to a great extent in regulating municipal services, its nominal authority to do so represents a risk to potential private sector investors in municipal infrastructure (see Section II 2 3)

Intergovernmental Transfer

As noted above, Honduras municipalities receive an intergovernmental transfer This transfer, defined as "ordinary income" in the Municipal Law, is important to the present study in two ways First, at least 90% of the transfer monies are to be directly used to finance investments (Municipal Law, Art 91) Second, such transfers may play an important indirect role in mobilizing other sources of external income (e g , credit) by improving municipalities' apparent creditworthiness (Creditworthiness is apparent because transfers can be said to "mask" the underlying fiscal and fiduciary performance of municipalities) This role in accessing credit has been noted in Argentina, Brazil, Colombia, and Mexico, among other countries

The Municipal Law (Art 91) assigns 5% of national income from taxes to all municipalities [11] Unfortunately, however, to date the actual monies distributed through this transfer, including L 150 million in 1997, have represented only about 2% of national tax income Some L 225 million (of which at least 90% would have supported capital investments) were thus not transferred to municipalities in 1997 as required by law This discretionality — not uncommon in Latin America — obviously impairs the usefulness of this resource base to help finance municipal infrastructure

Allocation of the transfers between municipalities is based on a formula 20% equally divided between all qualifying municipalities and 80% based on number of inhabitants Such a clear-cut formula is advantageous in that it promotes transparency The Honduran formula does not, however, try to accomplish any particular goals, e g , reward fiscal effort, benefit the poor, support creditworthy municipalities attempting to borrow, etc

To summarize municipal financial capacity compared to other countries in the region, Honduran municipalities are in a relatively favorable position regarding revenue generation The sector enjoys a relatively broad set of revenue sources, including taxes, user charges, and an intergovernmental revenue transfer This revenue base, however, requires defending, particularly the real property tax (whose effectiveness has been undercut) and the revenue transfer (which has never been fully implemented) Certain sources (e g , the betterment levy) could likewise yield greater returns then they are currently producing

Municipal income for 1992, the most recent year for which comprehensive data were available, is summarized in Table 1 7 One notes that, unlike other capital cities in Central America, Tegucigalpa does not absorb excessive levels of municipal revenues

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[11] This does not apply to port municipalities, which receive a transfer that amounts to 4% of port-generated revenues

Table 1 7[12]
Municipal Income, 1992

Source	Income for 1992					
	Tegucigalpa		Other Municipalities		Total	
	US$ mil	%	US$ mil	%	US$ mil	%
Current Income	8 9	70 6	25 1	50 0	34 0	54 1
- Taxes	8 6	68 3	16 3	32 5	24 9	39 6
- Service charges	0 3	2 3	8 8	17 5	9 1	14 5
Capital Income	3 7	29 4	25 1	50 0	28 8	45 9
- Betterment levy	0 4	3 2	2 9	5 8	3 3	5 3
- Transfers	2 4	19 0	11 1	22 1	13 5	21 5
- Other	0 9	7 2	11 1	22 1	12 0	19 1
Total	12 6	100	50 2	100	62 8	100

1 2 3 Use of Municipal Resources for Capital Investment

Together, current income and capital income have to pay for municipalities' current expenditure as well as support capital investment The law restricts the use of the various sources of income in a way that tends to encourage capital investment The Municipal Law requires that, at a minimum, the following resources be applied to capital investment

- Current income sources
  - At least 50% of current income to be applied for non-operating expenses, including capital investment (Art 177)
- Capital income sources
  - Betterment levy (Art 142)
  - Donations and transfers (as individually specified) (Art 175)
  - Loans (Art 186)
  - Bonds (Art 187)
- Extraordinary income sources
  - All extraordinary income (Art 174)

Monitoring individual municipalities to hold them accountable for meeting such a series of requirements may be more difficult than tracking just one indicator, e g , total investment as a percentage of total expenditures

FUNDEMUN's analysis of executed budgets for 1996 for 20 medium-to-large municipalities showed that those municipalities were directing significant levels of their total revenues into investment For the average municipality analyzed, capital investments, worth about US$373,374, represented 51% of total expenditures Capital investment as a percent of total

[12] Perez M Jose Antonio, *Sistemas Tributarios de los Gobiernos Locales en el Istmo Centroamericano*, SIECA, July 1994

expenditures has generally increased over time The relatively few municipalities that had reported low levels of capital investment in 1994 (10%-20% of total expenditures) had achieved significant increases in investment by 1996

1 3 Support to the Municipal Sector

Several entities support municipalities in increasing their financial capacity and otherwise strengthening their abilities to provide services and guide development

1 3 1 Public Sector

The GOH provides minimal training and technical assistance (TA) directly to local governments There is no municipal development institute such as one finds in other countries in Central America, even though the Municipal Law calls for the creation of such an institute (Art 105) The Secretariat of Government and Justice (*Secretaria de Gobernación y Justicia*) has a unit that provides a limited amount of training and TA to municipalities, including on the administration of cadastres This Secretariat is charged by the Municipal Law with assisting municipalities with their budgets (Art 96)

The Controller General (*Contraloria General*) is charged with the fiscal oversight of the municipal finance system (Constitution, Art 222) Specific functions include external *ex post* auditing and a role in setting qualifications for municipal financial posts

1 3 2 Nonprofit Sector

The Association of Honduran Municipalities (*Asociación de Municipalidades de Honduras* [AMHON]) is a nonprofit civil institution, formed in 1962, made up of all municipalities in the country First among its objectives is the defense of municipal autonomy, particularly as reflected in the national policy agenda Another objective relates to the provision of technical assistance to municipalities The Association functioned as a dependency of the Secretariat of Government and Justice until 1992 Its subsequent reconstruction has provided greater autonomy AMHON's financial health compares favorably with other municipal associations in Central America Membership quotas are set at 1% of municipal current income — a sustainable source of finance

Partially compensating for the relative lack of governmental involvement discussed above, FUNDEMUN, a nongovernmental organization, is the largest provider of training and TA to municipalities in Honduras With support of the USAID MDP, this foundation works largely with the 30 or so largest municipalities (outside of Tegucigalpa) Under the USAID MDP, municipalities receiving training and TA from FUNDEMUN must make a 25% or 50% counterpart contribution for services rendered, with the remainder funded by USAID, paving the road to sustainability FUNDEMUN provides training to participating municipalities in a variety of topics, including municipal finance, cadastre, municipal administration, tax policy and collection, municipal infrastructure and services, and public participation

The USAID MDP supports training via short courses for municipal officials nationwide through the Central American Technological University (UNITEC) UNITEC has offered short courses at 12 different sites in municipal administration and finance, accounting, community development, urban planning, municipal legislation, and popular participation The University of San Pedro Sula graduated one class of municipal technicians, but that program is reportedly currently not active

Looking at the system that provides training and TA to municipalities as a whole, one is encouraged by the partially market-based approach to providing assistance to the 30 largest municipalities Future challenges include expanding support to the remaining smaller municipalities, as well as providing additional assistance in key areas (e g , certain components of financial management) to the larger municipalities

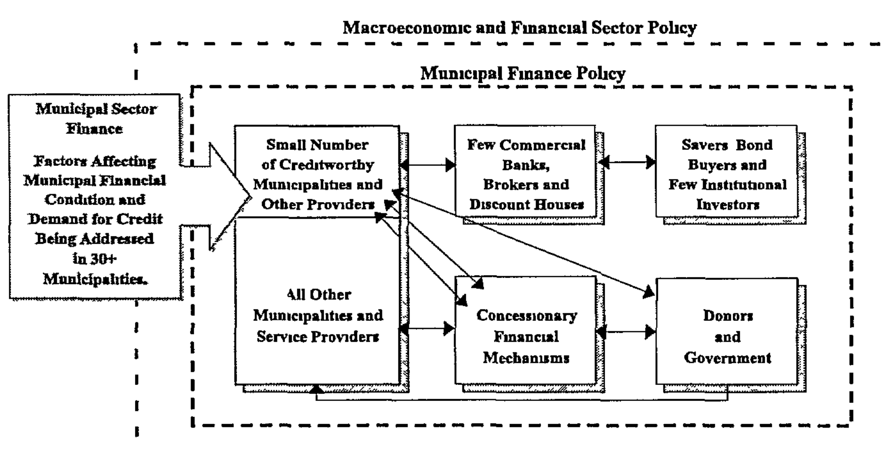
2 The Current Honduran Municipal Finance System

2 1 Current Sources of Municipal Finance

The current system for infrastructure financing by municipalities in Honduras differs considerably from the diversified and integrated system described in Section 1 This section describes the situation in Honduras as it exists today Exhibit 2, below, is an attempt to graphically represent this situation

The various arrangements used by municipalities to finance projects in Honduras is generally not seen as a system by most of those involved No explicit, coherent municipal finance policy under which municipal project financing can take place exists in Honduras, although the existing legal framework is generally supportive A number of local governments in Honduras are creditworthy enough to borrow or are receiving the assistance needed to become creditworthy (at least 30, it is estimated), yet the majority of funding available in the system is in the form of grants, which are allocated largely on the basis of need, rather than creditworthiness The limited concessionary debt funds are allocated on a similar basis A small amount of short-term bank financing does take place There is minimal coordination of municipal financing at the policy level, or between funding sources, and there are few incentives for the private financial sector to lend for municipal purposes

Exhibit 2
Municipal Finance System in Honduras



2 2 Funding Sources for Municipal Capital Investment

2 2 1 Public Sector and Concessionary Sources

Funding Sources

Municipalities have access to a number of public and concessionary funding sources in Honduras, although the total amounts available are relatively small [13] These sources range from grant funds, including government transfers, to debt funds loaned by the FHIS and provided by USAID The characteristics of each known source are discussed below Future funding levels are estimated in Exhibit 3, located at the end of Part II

Locally Generated Funds

As noted earlier (see Section 1 2 2), the major local revenues include taxes, user charges, and the betterment levy The law requires municipalities to use half of their income generated by taxes and charges for charges related to capital investment, including debt service All revenues from the betterment levy must also be used for these purposes In 1992, those requirements meant US$20 3 million from these two sources was available for capital investment In 1996, about L135 million or US$10 million was available from the central government transfer alone

In Exhibit 3, it is assumed that approximately US$25 million per year is available from this source

Central Government Transfers

Intergovernmental transfers are discussed in Section 1 2 2, above Transfer from central government are important for capital financing for three reasons 1) they can be used to directly finance capital investment (at least 90% of those funds must be used for this purpose), 2) transfers may also help mobilize other sources of external funds (especially loans and other forms of credit) by creating predictability and therefore lowering risk for investors (in many countries, intercept mechanisms give lenders a first claim on the transfers used as a form of security for market borrowing), and 3) transfers can also help improve municipalities' overall creditworthiness, depending on their level and how they are allocated

As noted earlier, actual monies transferred have not equaled the total required by law in Honduras Approximately US$10 million per year is shown as available in Exhibit 3

Grants from the *Fondo Hondureño de Inversión Social*

The Honduran Social Investment Fund (*Fondo Hondureño de Inversión Social* [FHIS]) has been a source of grant funding for municipal-type projects since it was originally created in 1990 as a mechanism to channel resources for Honduran social development FHIS I covered the years 1990 to 1995, and FHIS II was created in 1994 In 1995, the life span of the FHIS was extended to 12 years While the FHIS is an administratively autonomous organization, the Executive Director is a member of the government's administrative staff at the level of minister

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[13] Concessionality as used here means any characteristic that differentiates the funding from what would be available under market conditions including interest rate, loan term or other loan characteristic or requirement With the dearth of market-based resources available to municipalities, defining concessionality is difficult

The purpose of the FHIS is poverty alleviation and improvement in living conditions, and it focuses on the poorest sectors of Honduran society Over time, its objectives have expanded to where they now include job creation, the strengthening of civil society, including municipalities and local organizations, environmental protection, targeted support to ethnic communities, and increasing the sustainability of FHIS projects The FHIS characterizes its role as "promotion, financing, and supervision of projects "

The FHIS develops grant-funded projects in six sources education, water and drainage, health, municipal projects, social assistance, and environment (However, a program cosponsored with USAID provides loans, as described below) A total of L1 42 billion or approximately US$184 million has been contributed to the FHIS between 1990 and 1996 The primary sources have been the donor organizations and the Honduran government, including the World Bank (30 50%), the Inter-American Development Bank (IDB) (25 28%), the national government (15 81%), the German government/KfW (11 20%), USAID (8 17%), OPEC (2 95%), and others (6 07%) For detailed data on FHIS activities, see Annex 3 The most recent IDB loan approved for the FHIS was in June 1995 for US$60 million

A variety of applicants receive funds from the FHIS, including schools, NGOs, hospitals, and cooperatives Municipalities are the largest "applicant" (i e , recipient) class, both by the amount of funding (72 2%) and number of projects (74 3%) The average municipal project is small (L151,000 or US$13,000), about average for FHIS projects The next-largest class is governmental organizations (12 4% of funding and 7 4% of projects), and these projects have nearly the largest average size of all (L257,000 or US$22,000) The largest projects are those for hospitals and centers (average L284,000 or US$24,400), although these projects make up only 4,272 projects or 0 3% of all projects The sectoral concentration of FHIS fund (more than 70%) has been spent in education, health, and social programs Water and drainage, environment, and a general category called "municipality" make up the balance of the funding targets

Because poverty alleviation is a primary objective of the FHIS, the organization monitors the geographic allocation of its funds relative to the levels of poverty in each department, taking into consideration population distribution and employment generated per sector as a result of its projects The performance on the poverty alleviation objectives is shown in Table 2 4 in Annex 3

Since 1990, USAID has provided grant resources to the GOH for TA to promote fiscal responsibility and increased revenue collection in municipalities under the MDP In connection with this project, USAID has provided loan funds to Honduras for municipal infrastructure loans that are overseen by the FHIS under its Employment Generation Unit This is considered a special program of the FHIS, not included in the statistics above

Beginning in 1990, USAID gave US$14 5 million to the GOH for urban development, from this, a total of 398 projects worth L132 million were executed during FHIS I and II In 1994, the GOH contributed US$5 million and USAID US$10 6 million to the FHIS to provide credit to municipalities for basic municipal infrastructure (water, sanitation, and solid waste) An additional US$8 5 million of funding from combined grant and loan sources is expected to be added in 1998 Qualifications for receiving these funds currently include the municipality's involvement in the technical assistance activities related to the MDP, ability to implement cost recovery measures and repay the loan, and need

FHIS III and the Role of FHIS in Municipal Finance

Recently, the FHIS has released proposed policies for the next phase of its activities — FHIS III A new objectives is strengthening of municipalities and community organizations in the poorest areas Poverty alleviation remains a principal objective The FHIS has also expressed concern about the lack of sustainability in its activities and the need in FHIS III to address cost recovery of projects and its own institutional sustainability

The FHIS operates under incentives different from those of municipal lenders The grant-making activities of the FHIS could potentially support municipal borrowing by co-financing credit-worthy municipal projects with financial institutions, thereby lowering the total borrowing requirement on particular projects and providing a type of credit enhancement to the private lender However, the tendency of the FHIS to work in the poorer areas, in fulfillment of its poverty alleviation mission, could make this role difficult to play It has also been suggested that FHIS could become an intermediary for municipal credit funds Yet experience shows that developmental lending and technical support are better provided from separate organizations Such a separation would require a new lending entity for municipal investment

[In Exhibit 3, it is assumed that FHIS expenditures for the forecast years are at the levels shown in the FHIS III proposal]

Banco Municipal Autónomo

Banco Municipal Autonomo (BANMA) is a state municipal credit institution that was created in the mid-1960s to provide technical assistance to municipalities and to serve as a financial intermediary for them As of late 1993, BANMA had financed 170 loans in about 60 municipalities, according to the World Bank, but was in a poor financial condition owing to arrears by the majority of municipal borrowers Having been designed to operate as a sort of revolving fund for municipalities, the source of BANMA's resources has been the development agencies (USAID, the World Bank, and the IDB) The last major infusions of funds were made by the IDB and the World Bank The World Bank's US$6 9 million Municipal Development Pilot Project (MDPP) was approved in 1985 and closed in 1990 This project included more than US$6 million for preinvestment studies and sub-project financing However, only US$2 5 million was ultimately disbursed for all purposes related to the project

Municipal lending by BANMA has effectively ceased, and many of the outstanding loans remain in arrears and are not being paid by municipalities This is especially true of those loans made before municipal governments were elected, many were developed without municipal input or full consent Some projects were poorly conceived and produce no revenues for the municipality Periodic efforts are made by the GOH to collect on the outstanding loans, as was also done under the MDPP, described above The ambiguity regarding the status of BANMA's loans is a matter of concern in the context of the overall Honduran municipal finance system for two reasons First, the status of these loans and their resulting impact on the financial condition of municipalities is unclear, not only for the municipalities themselves, but for potential future lenders Second, the lack of resolution of these loans makes it difficult to establish a more strict, commercial credit culture in the municipal sector

[No future lending by BANMA is assumed in the summary of available resources (Exhibit 3)]

Government of Honduras

Until 1991, direct loans were made to municipalities from the Central Bank of Honduras, Secretary of Finance, and the GOH, according to figures supplied by the *Direccion General de Credito Público* During the period of 1982 to 1991, a total of L 160 million were lent to municipalities, generally the capital and other large cities, in this way However, it is assumed that this form of lending is no longer carried out in Honduras, and no projection of future direct lending is shown

Direct Loans from the Inter-American Development Bank

Municipal lending by the IDB is generally done through a central government intermediary, such as the FHIS or BANMA, often directed at a particular sector, such as water A small number of municipalities in Honduras are, however, candidates for direct loans from the IDB Currently, three loans are in process or have been recently approved by the IDB that will benefit the municipal sector the US$13 8 million loan to Puerto Cortés for water and sanitation, a loan to the GOH for US$15 million to carry out metropolitan development activities in the Sula Valley, and the US$40 million water and sanitation investment loan program with the GOH

Only one of these loans is to be made directly to a municipality the loan with Puerto Cortés for US$13 8 million to "build a wastewater disposal system and to reform the city's water and sanitation services to ensure broader, better coverage and sustainability "[14] This loan was approved in November 1997, for a loan term of 40 years, with a grace period of four-and-a-half years The interest rate will be 1% for the first 10 years, and 2% for the balance of the loan term Local funds of Puerto Cortes total US$2 4 million dollars Puerto Cortés would appear to be one municipality that could afford a less concessionary loan

The other loans mentioned are not approved, and their impact on the affected municipalities is a matter of debate in Honduras However, these examples are given to demonstrate that certain IDB lending activity is targeted directly to the municipal sector

[For purposes of the accompanying table, the assumption is made that IDB resources of US$15 million are available per year for the municipal sector, although future amounts may be greater or less]

[14] Source IDB Approves $13 8 million for Sanitation in Honduras press release dated November 20 1997 (http //www iadb org/prensa/1997/cp27297e htm)

Preinvestment Funds

The GOH has established a preinvestment facility, the *Fondo Hondureño de Preinversion* (FOHPREI), which lends money at concessionary rates of interest to municipalities and others to assess the prefeasibility of water, wastewater, and other projects The IDB has funded FOHPREI, and these feasibility studies have also led to project financing from the IDB, as well as BANMA and others Preinvestment funds are very important to the development of the municipal finance system, a need of US$500,000 per year in preinvestment funding is forecast in Exhibit 3

By partially subsidizing the cost of technical assistance under the MDP, USAID in effect provides partial funding for preinvestment activities Municipalities contribute a financial match at various levels depending on their financial capacity This approach is helping establish the municipal practice of hiring private consultants and increasing the pool of technical experts in the country

2 2 2 Private Sources of Municipal Finance

Commercial Bank Loans

Many municipalities in Honduras have established relationships with commercial banks Banks handle and invest municipal cash balances and, in some cases, provide administrative services, such as the collection of tax payments from citizens On a limited basis, banks also provide short-term loans, especially for equipment purchases and paving Security includes the equipment itself and a claim on the central government transfers Two banks in particular are active in providing loans to municipalities Banco de Occidente and Banco Atlántida Banco de Occidente charges municipalities a preferential interest rate 1% to 2% lower than that for other loans of similar terms According to bank officers of Banco de Occidente, it is a corporate strategy to be the bank of the municipal sector Other banks lending to municipalities include Bancahorro and Banco Sogerin To date, municipal lending appears to make up a very small portion of the bank's portfolios

Larger municipalities, such as San Pedro Sula and Tegucigalpa, have been able to borrow significantly larger sums from commercial banks, generally without extensive credit analysis Larger municipalities generally have an easier time borrowing, regardless of their financial condition, because of the availability of higher-value property and other assets to pledge as security

Municipal lending presents a number of risks to banks, including the political risk that debts incurred by one mayor will later be repudiated by another This generally limits loan terms to four years or less The short-term nature of savings in Honduras (generally less than one year) also creates risks for the banks, due to the mismatch in term between longer-term loans that municipalities may be seeking and the short-term deposits that would be the source of funds for the loans Uncertainty about the legal status of security arrangements, such as claims on the central governments transfers and municipal assets, add another level of risk for banks

[In Exhibit 3, the assumption is made that currently US$5 million in bank loans are outstanding, and that five years from now 20 municipalities could attain an average of a bank borrowing level of US$500,000 per year for an annual bank lending level of US$10 million in 2002]

Municipal Bonds

There has been one municipal bond issue in Honduras, for construction of a sports complex in San Pedro Sula, in the amount of US$15 million, with a term of six years (including a two-year grace period on principal repayment) and an interest rate of 11%, denominated in U S dollars A special-purpose corporation was formed by the municipality to run the stadium, however, the municipality is ultimately liable for repayment of the debt The security for the bonds is income from the sale of seats and boxes in the stadium as well as future revenues of the municipality Because no secondary market exists for the resale of bonds, these instruments do not trade The relevance of this experience to other municipalities may be limited, but it appears to demonstrate that the legal framework for municipal bond issuance is largely in place in Honduras

[In Exhibit 3, the assumption is made that by 2002 a total bond issuance and/or pooled financing (see below) of US$20 million per year could be taking place in the entire municipal sector]

Leasing

In many countries, including some with developing financial sectors, municipalities acquire capital equipment (fire trucks, wastewater treatment equipment, computers, etc) through leasing In essence a form of privatization, the private owner of the asset retains title and arranges a long-term agreement that allows the municipality beneficial use Honduran municipalities use leasing to a limited extent, for computer equipment and some vehicle purchases They are apparently restricted to leasing new vehicles, which limits the appeal of this approach No figures are available on the extent of this practice The potential for expanded municipal leasing activities in Honduras should be explored

[The assumption is made that US$2 million per year of leasing is taking place and that this will increase by US$1 million per year to 2002]

Privatization

The use of privatization as a mechanism to increase financing for the municipal sector is expanding quickly in Honduras Privatization creates access to financing for municipal purposes in two ways a) the private firm may have access to financial resources not available to the municipality, and b) improvements in the operation of the service may enhance the financial condition of the municipality and make it possible to borrow for other purposes

USAID/Honduras has been involved in the privatization of central government functions for several years under its Privatization of State-Owned Enterprises project Resources remaining under that project have recently been committed to support privatization of municipal services Ten local government privatization projects have already been implemented, 10 are in development, and additional municipalities are assessing the potential to use this approach Completed projects include markets, garbage collection, bus terminals, and slaughterhouses

These privatization projects are a pragmatic solution to the problem of the limited credit available to municipalities In the case of one market privatization, the individual vendors have received personal loans through a credit union to finance improvements in the market The security for this loan is the personal income of each vendor and the lease for the market signed between the city and cooperative This approach takes advantage of the better credit access enjoyed by individuals than municipalities in Honduras

[In Exhibit 3, it is assumed that US$1 million of what would otherwise be municipal financial requirements are satisfied by privatization today, growing by US$1 million per year]

2 2 3 Sources Not Available to Municipalities

Greater Access to Capital Markets

Municipalities generally do not have access to a capital market in Honduras, either directly or through the financial system This can be attributed to shortcomings in the market itself, lack of institutional support, and limitations in the municipalities' capacity to borrow As discussed below, the Honduran capital market is not effectively organized, nor are there significant long-term funds in the market that the municipalities can tap into However, reforms under way are expected to improve conditions for borrowing over the next few years

In well-developed capital markets, a complex of private firms exists to facilitate borrowing Some of these intermediary organizations exist in Honduras, but do not serve the municipal sector Examples of these institutions and their roles include the following

Intermediary Institution	*Role*
Investment (or merchant) banks	Structure projects and carry out primary sale of securities
Trustees or fiduciaries	Handle the administrative details of bond securities (payments, etc) during their term
Financial advisors, auditors, and other consultants	Provide technical expertise related to financial transactions, and organize and present disclosure information required by investors, increase information flow
Credit rating agencies or other credit evaluation capacity	Provide objective, third-party assessment of municipal financial condition, increase information flow
Bond insurers	Lend creditworthy municipalities their superior credit rating, for a fee
Bond trading systems or liquidity facilities	Create a secondary market in bonds, ensuring that investors can sell their position, if desired

Short-Term Market Financing

In developed markets, municipalities often may issue short-term instruments, such as commercial paper, to raise cash for specific short-term purposes and in anticipation of income, such as tax revenue In markets where loan terms are short, this type of financing may be feasible even when longer-term financing is not In Honduras, the central government issues treasury notes and private firms issue commercial paper, but municipalities have not issued short-term instruments

The treasury finance system is a factor favoring the development of an expanded short-term municipal finance system, even though municipal financial instruments will be different from treasury securities Because there are treasury securities, systems exist for the brokerage of government securities, and investors are accustomed to holding securities of the public sector Also, interest rates on treasury instruments can serve as the baseline (or "reference rate") for pricing municipal securities, as they do in many countries

Expanded Bank Financing

Municipalities' existing experience with bank borrowing was discussed earlier, but deserves to be highlighted The banks that are taking the initiative to provide financial services to municipalities are breaking important ground and these activities should be encouraged If banks are to provide more extensive and more long-term financing options to municipalities, experience in Central America shows that there are two major impediments to be overcome a) the unfamiliarity of banks with the municipal sector and its requirements (and vice versa) and b) the banks' limitations with raising funds appropriate for municipal lending, given the short-term nature of most savings available to them In effect, banks are victims of the same capital market limitations experienced by the municipalities trying to borrow directly These issues are discussed in more detail in Section 3 4, below

PROMUNI

PROMUNI is a regional loan facility created to make infrastructure investment capital available to municipalities from the region's intermediary financial institutions (IFIs) using funds provided by USAID under a loan to the Central American Bank for Economic Integration (CABEI)

PROMUNI operates in Guatemala and Costa Rica, and start-up activities are taking place in El Salvador After an extended start-up period, the PROMUNI project has been embraced by the key participants in the financing system established by the project the IFIs and the municipalities and NGOs who are the borrowers CABEI is seeking additional funding for the program, since the US$20 million in loan funds originally committed to the project by USAID, as well as CABEI's US$6 million counterpart contribution, will soon be fully loaned to municipal borrowers

In addition to the project investments made as a result of the program over the last four years, other benefits include the expanded contact between the IFIs and municipalities Since the IFIs carry out the loan analysis and structuring activities, and bear the repayment risk, the program has also introduced municipal borrowers to the discipline of the marketplace

To date, the PROMUNI program has not been introduced in Honduras In Honduras, as in other countries where PROMUNI is operating, the question of long-run sustainability of this approach would need to be addressed, but the short- to medium-term benefits could be considerable

[Exhibit 3 assumes the US$5 million in funding will be made available through PROMUNI over the next five years]

Pooled Financing Vehicles

While no panacea, pooled financing (or multi-project financing) mechanisms, such as so-called "bond banks," can provide indirect access to financial markets for municipalities when direct access is too costly for borrowers or when investors consider direct municipal investments too risky These entities issue bonds in the market, and the proceeds are loaned to municipalities, based on strict criteria that preserve the credit quality of the entity overall

A pooled financing vehicle can be an independent financial intermediary or may be a subsidiary of an existing institution with a purpose limited to municipal financing It can overcome certain hindrances to municipal credit access, including lack of credit quality standards in a market (the entity can enforce these standards), high transaction costs (the pooled nature of the financing can lower average costs), and the need for credit enhancement (the entity itself can be insured, rather than each individual transaction) However, it is difficult for such an entity to overcome basic market weaknesses, such as high interest rates or lack of long-term investment funds

[In Exhibit 3, the assumption is made that by 2002 a total bond issuance and/or pooled financing of US$20 million per year could be taking place in the entire municipal sector]

2 3 Legal Context for Municipal Finance

Two aspects of the municipal legal framework are particularly relevant to the discussion of municipal finance 1) restrictions on municipal access to finance, and 2) limitations on municipal public-private partnerships (which could involve infrastructure finance)

2 3 1 Municipal Access to Finance

Law and regulations define municipal access to external sources of finance For instance, the servicing of all forms of debt must not exceed 20% of a municipality's ordinary income (Municipal Law, Art 89) This form of quantitative restriction, which attempts to preserve some level of municipal autonomy while protecting against excessive borrowing, follows models developed elsewhere in Latin America (e g , Costa Rica, Argentina)

In addition to this restriction, the Honduran legal framework establishes three different paths for municipalities to access finance As shown below, central government involvement in the process varies, depending on which route is chosen

Domestic Borrowing In 1991, the GOH liberalized the law permitting municipalities to contract domestic loans and perform other financial operations with minimal central government involvement (Municipal Law, as reformed, Art 87)

Domestic Bond Issuance Municipalities seeking to issue bonds, even to domestic investors, must seek central government approval The Secretariat of Finance and the Central Bank must both sign off on all bond flotations (Municipal Law, Art 88) This approval requirement further restricts municipal autonomy beyond that imposed by the quantitative restrictions noted above These requirements may also influence the development o the municipal finance system in unintended ways by favoring one debt instrument over another (loans require fewer administrative procedures than bonds)

International Debt Municipalities wishing to seek international financing face the most extensive process of central government approval (Municipal Law, Art 87) The Law of Public Credit (LPC) (Decree No 111-90, September 1990) charges the Department of Public Credit of the Secretariat of Finances with negotiating such public debt obligations (Art 22) The projects to be financed need to appear in national capital investment program (LPC, Art 21), be assessed for feasibility, and be reviewed by the Central Bank and others (LPC, Art 24) Both the Department of Public Credit and the National Commission of Public Credit then play a role in authorizing or rejecting the request (Executive Decree No PCM-018-96) The President of the Republic finally has to approve the loans, meeting with this Cabinet of Ministers (LPC, Art 26, Executive Decree No PCM-018-96)

Some streamlining of the process for accessing international finance appears desirable, including reducing the number of authorities involved The law might distinguish between public and private sources of international capital, this is not currently the case (e g , Executive Decree No PCM-018-96) The law might also allow more flexibility in negotiating the terms of credit Without these changes, the legal framework may unnecessarily restrict international flows of private capital to finance municipal investments

Arguments in favor of a high level of central government control over external borrowing by municipalities include the need for foreign exchange control and the "commitment problem" — that is, that the central governments may find it difficult to avoid a bail-out of a local government that finds itself in financial trouble if exchange costs increase Central government control over subnational external borrowing is very common in Latin America Of 18 countries surveyed in the region, only one (Ecuador) permits subnational governments to borrow externally without authorization from the central government

2 3 2 Municipal Public-Private Partnerships

The legal rights of municipalities to enter into public-private partnerships related to service provision also affects municipal finance Laws that permit flexibility in reaching privatization and concession agreements may lead to greater private sector investment in municipal infrastructure, e g , via build-own-operate-transfer contracts and other similar arrangements

The two primary laws governing public-private partnerships are the Municipal Law and the Law for Contracting with the State (Decree No 148-85[1], as amended) The legal framework does not consistently promote public-private partnerships in municipal infrastructure On one hand, it is relatively progressive it permits municipalities to contract with private companies to install public works and provide municipal services, as well as to recovery their costs and obtain a "reasonable" return on their investment (Municipal Law, Arts 14-15)

On the other hand, certain parts of the legal framework do not provide a clear structure conducive to public-private partnerships The Law for Contracting with the State, for example, restricts the periods for which many types of public (including municipal) contracts are in effect Those contracts are only in effect for one administration, the National Congress needs to approve any contracts that extend into a second administration (Art 9) Because attracting private investment via a public-private service agreement often requires a long-term commitment on the part of a municipality, these restrictions appear to severely limit the ability of local governments to attract private investment in this manner Private investment is also discouraged by laws that allow control by the central government over tariffs (discussed in Part II 1) and by restrictions on finding the most cost-effective way to provide a service (e g , requiring service providers to purchase only new vehicles)

2 4 The Honduras Macroeconomy and Financial Market Conditions

As shown in Exhibit 1 (page 12), the policy frameworks for the macroeconomy and the financial market have considerable impact on the availability of funds for municipalities These influences are explored below

2 4 1 Macroeconomic Factors

As noted above, Honduras is a poor country, approximately 70% of its citizens live below the official poverty line Since the 1980s, economic conditions in the country have not significantly improved Inflation has risen, real wages have fallen in 6 of the last 10 years, and conditions in the economy have discouraged investment and held back development of the financial sector At the same time, Hondurans have experienced reduced GOH subsidies in many sectors, higher tariffs for a number of services, increases in the costs of goods, and expanding unemployment These harsh conditions have come about partially as a result of the implementation of a series of structural reform programs in the 1990s There have important accomplishments as a result of these reforms, including the privatization of public enterprises and reduction in the size of the central government labor force Those programs were intended to yield long-term benefits reduced inflation, increased savings, reduced public debt, and economic growth, yet, due to inconsistent application of reform policies, not all affects have been positive High inflation and high interest rates have been the norm in Honduras for the past decade

While high interest rates would appear to be favorable for the supply of savings, they discourage investment by raising the cost of projects and lowering the affordability of services High-interest-rate economies also often fail to produce long-term savings instruments, since there is no incentive to invest in riskier long-term investments (which would generally pay a higher interest rate) when interest rates on short-term investment are nearly as high This phenomenon is found especially in places, like Honduras over the past decade, where interest rates continue to rise or remain high

The prospects for continuing reform of macroeconomic policy in Honduras, and the resulting effects on the municipal sector, are as yet unclear Decisions yet to be made by the new administration will have great influence on the feasibility of expanding the availability of financial resources for municipalities, at least those from the private market Yet some of the reforms that may be needed to improve government's financial condition could lead to lower levels of concessionary funding, including transfers, from the central government in the short run Establishing lower and less volatile inflation and interest rates, and creating a deeper capital market in which investors have confidence, are essential prerequisites to the ideas discussed in this assessment

2 4 2 The Banking System

According to a recent internal report of the IDB, Honduras has a small banking sector, when measured by the amount of funds on deposit in banks relative to the GDP of the country [15] Only foreign currency deposits can be shown to have grown significantly since 1990 Honduras's level of deposits in the banking sector relative to GDP is less the one-half of the average for the rest of Central America However, *financieras*, which take deposits but are not under the same regulatory requirements as banks, have grown as well and are not captured by banking sector statistics

Some recent regulatory reforms appear to bode well for future availability of funds The reserve requirements of banks with the central government have been lowered (although were still at 31% at the end of 1997), freeing some new resources for lending and potentially resulting in higher deposit rates as bank operating costs fall Furthermore, the government has ceased to be a primary borrower from banks, thus making additional funds available These additional funds have led to growth in liquidity and lending to the private sector that concerns some, since underwriting standards and financial reporting in Honduras are relatively weak If municipalities were able to present a better credit risk to financial institutions, they might find interested lenders

Interest rates on savings in Honduras are relatively low, even during periods of high inflation As a result, real interest rates (savings deposit rates minus inflation) offered to savers in Honduras have been negative during much of the last five years GOH bonds are issued partially for the purpose of absorbing liquidity and controlling inflation These bonds have historically paid higher rates than bank savings, and therefore compete with banks for funds (Although in the past several months, treasury rates have fallen more in line with bank interest rates)

Table 2 1
Honduras, Rates of Inflation and Interest, 1988-97

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Inflation (CPI) %	2 5	4 5	9 9	23 3	34 0	8 7	10 8	21 7	29 5	23 8
Interest rates on bank borrowing %	15 2	15 3	15 3	17 5	22 0	21 5	22 0	25 0	28 4	30 0

[15] "Honduras Sistem Bancario, internal memo May 28, 1997, IDB

The cost of borrowing from banks is high in Honduras due partially to a lack of competition in the banking sector Only Guatemala's intermediation costs are higher The spread between deposit and borrowing rates in Honduras has recently ranged as high as 16%

As a result, corporations often raise funds by issuing notes (*pagares*), which have some of the same benefits for investors as bonds Brokering houses, generally owned by banks, assist private firms with the issuance process

Other weaknesses of the financial sector identified by the IDB include the short-term nature of the deposit base, due to volatility in the economy and the lack of deposit insurance Insufficient capital requirements for banks make it difficult for them to manage the risk of mismatch between short-term deposits and longer-term loans This situation promotes overly conservative, short-term lending Limited credit analysis by some banks also contributes to conservatism In addition, most banks have a significant quota of non-performing loans, although the lack of information makes it difficult to establish their exact level Court procedures make it difficult for banks to collect on collateral associated with loans and result in extended periods before loan defaults are cured Connected lending (lending to companies in some way associated with the bank) makes defaults harder to identify and provides a weak incentive for banks to develop more objective credit criteria

The condition of the banking system does not invite great optimism over its role in helping build an expanded municipal finance system However, recent regulatory changes could improve conditions in the banking sector over time and in the financial sector generally, with potential benefits for the municipal finance system The Law of Financial Institutions passed in October 1995 put ceilings on the portion of a bank's lending that could be placed with any particular borrower This lowers the risks (and potential costs) related to the common bank practice of portfolio concentration and potentially opens up bank lending to new borrowers In 1996, the National Banking and Insurance Commission was created If successful, the Commission should regulate the level of bank reserves, reduce the practice of connected lending, and improve overall banking practices (This entity, however, was not fully operational as of 1997)

2 4 3 The Capital Market

The poor development of the capital market is also an issue in considering how to raise funds for municipal development Funds enter a capital market when securities of various terms are offered for sale Buyers may be either institutional investors (pension funds, insurance companies, mutual funds, etc) or retail investors (individuals and other small holders) When pension funds, for instance, invest funds left on deposit with them, it is ordinarily for the long term (5 to 20 years) If liquid and well managed, these institutions can potentially make an enormous contribution to the availability of long-term funds in developed capital markets

In Honduras, however, the pension funds are small and operate under more of a "pay as you go" approach to meeting pension obligations Those funds that do have substantial funds for longer-term investments, such as Injupemp and Inprema, have directly invested in such projects as affordable housing, which have often not paid off financially for them In other cases, the assets of these entities may not be liquid, as government bonds paying below-market interest rates have been given to them by government in lieu of required cash contributions

The low rate of capitalization of the pension funds represents an impediment to the development of an expanded capital market in Honduras There are numerous reforms proposed for the pension funds that would contribute to their capitalization, including privatization and the development of capitalized interest (or defined contribution) accounts, which would be funded with proprietary funds of the pension fund contributors All of the proposed reforms are expected to be politically difficult to get approved, and few are expected in the short run

On a more positive note, the new Law of the Central Bank limits GOH access to the Central Bank and encourages issuance of treasury securities As discussed earlier, the existence of an active treasury securities market can help pave the way for municipal securities (municipal bonds), by helping establish the institutions required to market, sell, and trade them, although currently no formal secondary market exists in Honduras for Treasury securities The existence of a treasury market also creates investor familiarity with GOH "paper" that makes the sale of municipal securities easier

Exhibit 3 Funding Sources Available to the Honduras Municipal Sector for Infrastructure Investment (1)
1994 2002 in thousand US $

Sources of Funds for Municipal Investment	Totals	Actual 1990	1991	1992	1993	1994	1995	1996	Projection 1997	1998	1999	2000	2001	2002
Public and Concessionary Funding Sources														
Municipal Own Source Revenue	$221,408			20,300	0	0	0	24,700	25,935	27 232	28 593	30,023	31,524	33 100
Central Government Transfer	$91,188			12,150	0	0	0	7,000	9,450	9 923	10 419	10,940	11,487	12 061
FHIS	$50,523			8 079	6,653	2,428	3,423	12 928	4,678	1,917	3 083	2 500	2,333	2 500
USAID/FHIS EGU														
FHIS I	$8,274	2,069	2 069	2,069	2,069									
FHIS II	$6,226					2 075	2 075	2,075						
CABEI I	$9,000						3 000	3 000	3 000					
CABEI II	$4 900									1 633	1 633	1,633		
Child Survival	$3 250									1 083	1 083	1 083		
BANMA	$0	na	na	na	na	na	na	na	0	0	0	0	0	0
Government of Honduras	$46,028	36,300	9 728	0	0	0	0	0	0	0	0	0	0	0
Direct Loans from IDB	$90,000								15,000	15 000	15 000	15 000	15 000	15 000
Private Funding Sources														
Commercial Banks	$45,000								5 000	6 000	7,000	8 000	9 000	10 000
Municipal Bonds/Pooled Financing	$105,000							15 000	0	16 000	17 000	18 000	19 000	20 000
Leasing	$27,000								2 000	3 000	4,000	5,000	6 000	7 000
PROMUNI	$5,000									1 000	1,000	1 000	1 000	1 000
Privatization	$21,000	0	0	0	0	0	0	0	1,000	2 000	3 000	4 000	5 000	6 000
Preinvestment funding	$3 500						250	250	500	500	500	500	500	500
Total Funds Available	$737 297	$38,369	$11,797	$42,598	$8 722	$4,504	$8,749	$64 953	$66 563	$85,288	$92,312	$97 679	$100 844	$107 161
Projection of Municipal Investment Requirements														
Estimated Funding Requirement 30 munis/water sanitation solid waste	$537,770	na	na	na	na	na	na	na	65,870	76 210	85 810	97 680	111 930	100 270
Estimated Funding Requirement Others	$133,000	na	na	na	na	na	na	na	16 000	19,000	21,000	24,000	28 000	25 000
Carryover from Prior Years	$246,807	na	na	na	na	na	na	na	na	15,307	25,230	39 728	63 728	102 814
Investment Requirements	$917,577								$81 870	$110,517	$132,040	$161,408	$203 658	$228 084
Net Funding Requirement									($15 307)	($25 230)	($39,728)	($63,728)	($102,814)	($120 923)

1 Projection of funding requirements is based on population forecast for 30 largest cities extrapolated from UNDP estimates and converted to an assumption about increases in the number of households Investment requirements cover water sanitation and solid waste only and assume that investment per new household would be $1 350 $900 and $500 respectively Unit costs are forecast to increase at 7% per year Total investment requirement for all other municipalities is set at 30% of the total for the 30 largest cities Assumptions regarding increases in sources of funding are discussed in the report

3 Adequacy of the Current System and Key Constraints

The public and private funds projected to be available from the Honduran municipal finance system through 2002 are shown in Exhibit 3 The projection assumes increases in the relative importance of private funding — from only about 10% of total resources supplied in 1997 to more than 40% of the total in 2002 These gains are relatively modest, and take into consideration the current low levels of private funding

In spite of the fairly optimistic assumptions about new funding sources used to forecast these figures, Exhibit 3 shows a steadily widening gap between total funds available and the projected funding requirement over the next five years The shortage of total funding increases from US$150 million in 1997 to US$40 million in 2001 This widening shortfall points to the need to better articulate and develop the municipal finance system

Section II 1 and II 2, above, painted a complex background against which the municipal finance framework will need to be designed and illustrates a number of the limitations found in the current system As discussed in the Introduction, a critical step is gaining consensus, or at least general agreement, on the nature of the current situation In each aspect of the system described, there are numerous potential interventions The priority should be to address the most critical constraints on expanding the system (such as improving the policy environment for borrowing), and on carrying out other activities that will contribute to the long-term sustainability of the overall system (such as improving municipal financial soundness) The limited resources and available expertise must be used effectively, in order to realize the maximum possible benefit with the available resources

The following is a summary of the Honduras municipal finance system today, organized according to the list of“essential elements” identified in Part I For each element, the current situation is presented and the key constraints identified The next section of the report (Part III) then proposes activities that can address the identified constraints

- **Creditworthiness** Incentives exist to move local governments in the direction of greater creditworthiness, and the strongest municipalities are perceived as good credit risks

  Status in Honduras A small but growing number of municipalities are becoming creditworthy Overall, however, the perception is common that there is a high level of credit risk associated with municipal sector Some of this is justified and some of it is the result of unfamiliarity and the lack of information between the parties For smaller, poorer municipalities that will not soon become creditworthy by private standards, ways are still needed to finance projects in a sustainable and timely manner At the same time even poor municipalities may have specific services that are “finance-able,” even if their financial resources are generally limited The goal of improving creditworthiness should continue to be a cornerstone of development activities in the municipal sector

  Key constraints Lack of information is a key constraint with respect to the perception of creditworthiness Poverty and shortcomings in municipal management are constraints on the attainment of creditworthiness Because the material rewards for a municipality attaining creditworthiness are few in the absence of a well-functioning municipal finance market, an alternative incentive structure may needed, such as a public or public-supported financing entity that lends on that basis Experience in other developing countries shows that, for instance, the attainment of an investment-grade credit rating can become an important goal of municipalities, even when financing options are limited, but some options must be available

- **Information** A range of timely financial and other information about municipalities is available to creditors and others [16]

  Status in Honduras Quality public information about municipal finances and data about the municipal sector is very limited, although some improvement measures are under way, such as the development of accounting standards for the municipal sector Municipal finance information needs to be standardized, and made public on a timely basis, an especial challenge in a poorly-run municipality Improving information quality and quantity can be a relatively low-cost intervention in a developing market In some cases, just presenting existing data more systematically and publicly can be an important first step

  Key constraints An information improvement strategy for the municipal sector is needed to coordinate reforms affecting a wide range of information sources and organizations Its lack will be a real constraint Potential investors, and other interested parties, should be involved in the effort to standardize and provide information helping to ensure that the resulting information is to be of value to them In Honduras, as elsewhere, there is a preference to keep municipal level information confidential, which must be overcome Few benefits accrue from secrecy, but local governments are typically reticent to have their financial information made public

- **Technical assistance** Municipalities have access to affordable technical assistance (TA) on municipal finance matters and for project preparation

  Status in Honduras A competent cadre of professionals exists and is in formation in Honduras, partially as a result of USAID's support for FUNDEMUN and the high standards for technical support that FUNDEMUN has established Some municipalities hire consultants directly at full cost, but many receive assistance at a subsidized cost Competition in the provision of TA is a positive goal for a municipal finance system, because it encourages innovation, lowers costs, and contributes to quality However, lack of up-front funding for project development can limit municipalities' ability to hire needed assistance, no matter how plentiful it is USAID (through FUNDEMUN) and FOHPREI are two sources of assistance The FHIS is also a player in this arena and may expand its role as technical assistant to poorer municipalities under FHIS III If feasibility studies and project development costs

[16] Information needs include multi-year investment plans reports on financial performance of municipal sector generally and on specific financial transactions, municipal accounting standards and audits credit rating system, communication of successes and lessons learned

could be recovered from the proceeds of project financing, a more self-sustaining system for providing TA would be possible USAID, the FHIS, and the IDB should work with the municipal sector to increase funding and develop approaches to sustainably finance technical assistance to municipalities

Key Constraints Key constraints on the provision of technical assistance are the lack of resources at the municipal level for project development prior to the development of projects and for general assistance that may have no immediate financial payback The constraint on creating sustainability in the provision of technical assistance is the lack of mechanisms for fully recovering technical assistance costs from those assisted The first aspect of this should be recovery from projects that are successfully funded as the result of technical assistance, and partial repayment (as already practiced by FUNDEMUN) in all other cases

- **Expanded funding, appropriately allocated** A coordinated, transparent strategy is in place for best use of concessionary funding Municipalities who work to improve their creditworthiness are rewarded with expanded funding

Status in Honduras This is one of the most challenging aspects of the Honduran financial system for municipalities, and is compounded by the enormous shortage of funds for municipal investment Where adequate funds are being inappropriately allocated within the system, reforms are easier to carry out than where the overall level of funds is inadequate, as in Honduras Measures must be taken to increase the supply of funds available for municipal investment Private sector funds cannot be expected to fill the entire gap that currently exists, both because the funds are not available in the private market and because funds will still be needed for many municipal borrowers

Concessionary financing, such as that available through the FHIS, is being allocated according to social criteria, and is in short supply This is filling an important gap, but is a different motivation from that of the private sector Private funding sources should be more extensive, by only for borrowers who can overcome the creditworthiness hurdle More private sector resources are needed A public or public-private entity that does business more like the private sector, and is adequately funded, would appear to be needed now to fill the gap between the existing mechanisms and whatever additional financing the private sector will provide

A credit rating or credit scoring system for municipalities would support an approach under which financial resources are allocated on the basis of credit quality, rather than need This will accelerate the development and expansion of the financing system The assessments prepared by FUNDEMUN for USAID approximate this type of approach and could perhaps be used as the basis for the development of a municipal credit scoring system

Key Constraints Significant new funds is the most challenging constraint on this aspect of the system Resources are also needed to develop and gain acceptance for a credit scoring system for municipalities that can be used to help "graduate" them over time to funding sources awarded on the basis of credit quality, and away from those awarded based on need

Also, funding-constrained, need-based financing systems are often driven by political rather than economic motivations, providing no reward for well-managed municipalities This undermines development of the system, but changes may be resisted by those who benefit

- **Innovation** A range of financing sources are available A variety of transactions and financial structures are in use and are widely understood by local governments

  Status in Honduras Along with the shortage of funds and their poor allocation, the low level of involvement by the private sector in providing funds to municipalities is one of the most fundamental weaknesses of the current system The financial sector is constrained by the macroeconomy in Honduras, and by the lack of information available to them about this potential "market " How marketable municipal bonds or notes would be in Honduras is not well-known, so low levels of investor knowledge or interest is also a constraint (The San Pedro Sula bonds were largely bought by contractors involved in building the sports stadium) Expanded direct private financing probably is feasible, and pilot projects should be attempted For an interim period, however, a joint public-private intermediary may be needed to work with the financial sector and to test-market innovative financing approaches with municipalities while waiting for ongoing reforms of the financial sector to increase financial sector competition and innovation, and investor demand

  Key Constraints Building enthusiasm for the idea of innovation in municipal finance may not be easy in Honduras at this time, unless there is confidence that larger financial reforms will succeed Funds are needed for evaluating the feasibility of a new public/private entity and/or of designing innovative financial mechanisms, since the costs cannot be borne by municipalities Funding would be needed as well to help capitalize a new entity, if one is thought to be feasible

- **Legal/regulatory support** The legal and regulatory systems for municipalities, the financial sector and the macroeconomy support municipal finance

  Status in Honduras Honduran law is generally supportive of municipal finance, although there are revisions that may be needed, in both the municipal and financial sectors Examples in the municipal sector include changes to overly restrictive rate-setting powers in the municipal law and limitations on the ability to pledge assets as security Financial sector reforms include further leveling of reserve requirements to encourage saving, as well as numerous macroeconomic policy reforms Proposed water sector legislation is of concern, as it appears to contradict some other goals widely held for municipalities and potentially to remove an important source of municipal revenue

  Key Constraints Commitment is required for the municipal sector to become involved in policy reform, in areas such as macroeconomic policy which apparently stand outside of the normal range of municipal concerns The Honduras municipal sector has effective advocacy, such as through AMHON, which addresses municipal policy and law How this organization or others involved in the municipal sector might become substantively involved in the broader range of policy issues discussed in this report should perhaps be examined

- **Policy framework** A municipal finance policy or framework guides implementation

  Status in Honduras No comprehensive framework is in place in Honduras, policies have that affect the ability of the municipal sector to finance are made on something of an *ad hoc* basis However there appears to be an active debate on overall municipal policy, and the fora where this debate takes place could be used as the launching pad for development of a proposed more integrated municipal finance framework There is not a strong concept of the municipal finance system **as a system** and unfamiliarity with the idea that constraints should be addressed systematically As a first step, some general goals and indicators for municipal finance development might be established and used as a basis for reporting progress

  Key constraints Constraints may include the complexity and scope of a municipal policy framework, as shown in this report, and the potential for any "measuring stick" to reveal conflicts with other laudable development goals for the country The challenge will be to make the concept as clear and understandable as possible and to find reasonable trade-offs between development goals, while keeping all the essential elements under public discussion

- **Public-private dialogue** A forum exists that encourages a public-private dialogue on municipal finance and invites private sector involvement in the development process

  Status in Honduras There does not appear to be any forum of this kind taking place in Honduras As a consequence, the perspectives of the private sector are not well known or integrated into the thinking about the development of the municipal finance market Similarly, the financial sector is not now committed to meeting the needs of municipalities, and the municipalities do not know what it will take for them to become interested The constraints on an expanded system will require the development of a constituency for municipal finance, one which ideally would include individuals from both the public and private sectors It is important for this group to become educated and involved in broader policy discussions, such as those on macroeconomic policy to the extent that they affect municipal service provision Creating this forum could be the first step in facilitating this process

  Key constraints Overcoming initial disinterest or resistance on the part of the private sector will be a constraint on the development of an inclusive, effective forum The USAID/CABEI PROMUNI program, for example, took more than a year to carry out orientation activities with banks before they were willing to participate as IFIs An important step will be to identify a few key allies in the financial sector to provide leadership on this issue with their peers

Part III Action Plan — Toward an Expanded Municipal Finance System

1 Proposed Options to Strengthen and Expand the Municipal Finance System

Listed below are a range of strategies that could be employed to carry out the activities recommended in this assessment The options shown are generally not mutually exclusive, but are steps toward the development of a better system overall These options demonstrate that in each area improvements can be made, sometimes by means of very small, but important, steps

1 1 Encourage Continuing Improvements in Municipal Financial Condition and Communicate Results

Continuing efforts to improve the financial condition of municipalities, and increase the knowledge of the results within the country, are imperative for the development of an expanded system Efforts underway to develop indicators for defining and measuring progress in this area are commendable and should be given full support The number of viable municipalities needs to be expanded as well Coordination among various entities providing financial support for municipal development is also encouraged, to ensure that all essential investment requirements of the municipal sector are being addressed

Option 1 Continue to expand municipal development activities, guided by a set of standards that will help a larger number of municipalities to become creditworthy borrowers

Option 2 Develop a mechanism for donor and government coordination on municipal development activities related to finance in order to harmonize activities and share lessons learned

Option 3 Provide targeted financial supervision or intervention to poorer and smaller municipalities with the potential to become financially viable Representatives of a group of more creditworthy municipalities may be among the most effective providers of this assistance

1 2 Assist Efforts to Expand Financial and Other Information about Municipalities Usable by Creditors and Others

Lack of information can result in the failure of otherwise viable markets Often, important results have been seen from minimal intervention on this element Examples of the types of information necessary for financial system functioning have been mentioned before and include multi-year investment plans, reports on financial performance of municipal sector generally and specific financial transactions, municipal accounting standards and audits, credit rating system, and communication of successes and lessons learned

Option 1 Implement periodic reporting requirements on the financial operations/performance of the municipal sector The legal framework to facilitate improved information flows on municipal sector fiscal performance is largely in place, it should be implemented and enforced The LM spells out a series of reporting requirements This requirement should be enforced by the central government and encouraged by AMHON and FUNDEMUN The central government could then periodically compile and analyze the information collected — perhaps by publishing an annual report on the municipal sector — and make the data available (at cost) to interested parties

Option 2 Develop a credit rating system Creating a credit scoring system for municipalities, and expanding its use, could greatly enhance system development To be respected, credit ratings should ideally be done by a neutral and objective third party, generally in the private sector However, the demand for credit ratings, and municipal sector are both sufficiently small that no private party would likely be able to make a profit providing such a service in the short run, therefore, an interim strategy may be needed whereby the municipal sector itself develops standards and uses them to score the financial condition of municipalities

Option 2a Existing information, such as that available from FUNDEMUN assessments and that that may result from the development of municipal indicators, could be used as the basis for this system, at relatively low cost

Option 2b Adapt the performance indicators currently being developed for municipalities so that they can be used by the private sector or others to score (or self-score) municipalities and evaluate their creditworthiness Use the information from either or both of these systems to hold workshops with municipalities during which self-evaluation could take place

Option 3 Publicize expanded cost recovery and collections techniques and other success stories and lessons learned In spite of the prevalent view that many people in Honduras are too poor to pay for services, significant experience in cost recovery and revenue enhancement related to capital projects is being gained in Honduras, often after community participation and consensus building (e g , the toll road in San Pedro Sula) These cost recovery techniques are important because they test the limits of the municipal law and establish precedents Yet this body of experience is not being accumulated and shared throughout the municipal sector, allowing the lessons learned to be capitalized upon

Option 3a USAID could provide resources to have the range of experiences in cost recovery that have been gained in Honduras analyzed and documented in writing and circulated to the municipal sector through AMHON or other means

Option 3b The experience gained to date in cost recovery and revenue enhancement could be used as the basis of training for the municipal sector Presenters could include those municipal representatives responsible for the implementation of these participatory cost recovery approaches

1 3 Encourage Continuing Development of the Market for Technical Assistance

Encouraging innovation and affordable access to technical assistance is a key element of financial system development In particular, lowering the costs and time requirements related to the project development process can help to improve the affordability of the resulting investments

Option 1 The GOH and donors could make additional resources available for project development and for training and technical assistance to municipalities on basic aspects of public administration They should also attempt to organize the provision of these resources in such a way that the sustainability of these activities is increased — for instance, through the creation of a revolving fund

Option 2 Additional training modules could be explored for inclusion under the USAID MDP, particularly regarding administering the betterment levy and recovering costs for service provision, activities that would increase the amount of locally generated funds available for project preparation and human resource development

Option 3 FUNDEMUN could coordinate, on an ongoing basis, with other entities that provide training and technical assistance to municipalities Coordination would help ensure standard cost and quality in the provision of assistance The more market-based (rather than cost-based) approach to pricing project-related services under the MDP program with the FHIS is a positive step toward strengthening the market for technical assistance

1 4 Transparent Strategy for Expansion and Best Use of Available Concessionary Funding

As discussed throughout this report, the private sector is likely to expand its financing activities with local governments in Honduras only with some support from public or concessionary sources Support from the public sector can provide the "credit enhancement" or "risk management" sought by the private sector, while staying away from the idea of government guarantees, which are highly distortive Public sector support could range from co-financing on individual projects to joint capitalization of an intermediary for raising funds for municipal finance Currently, this is not understood to be an appropriate role for government, and funds overall are so inadequate that it is difficult to argue that available resources should be moved from currently targeted activities (largely poverty alleviation and other social needs) to leverage private finance However, some expansion of the government role in encouraging private finance is probably necessary if Honduras is to break the cycle of underinvestment within which it currently operates

Option 1 Address the issue of public-private coordination in municipal financing in the context of the proposed public/private forum (see below)

Option 2 Carry out an inventory of strategies used by the public sector to leverage private funds for local government in developing markets and use it as the basis for policy discussions between donors and central and local government

Option 3 Request a group of respected private sector representatives to propose via a written report and policy discussions how the GOH could support expanded private financing efforts

1 5 Support Innovation in the Raising of Investment Funds and Gain Additional Transactions Experience

In spite of the limitations presented by the current system, it is important to continue to attempt new types of transactions by municipal borrowers, assuming they can be carried out at costs affordable to municipalities Pilot final transactions and privatization projects bring to light the limitations of the policy framework and create urgency to resolve constraints They also inform potential users of approaches that should be (or should not be) considered The San Pedro Sula bond issue is an excellent example of a transaction that could be instructive to others in the municipal sector, however, the experience is largely unknown

It is also important to investigate options for introducing new institutions that can draw financial resources into the municipal finance system A wide variety of new intermediary models are being developed around the world for municipal infrastructure finance Some improve access the capital markets, others work through the financial sector In either case, important goals include maximum initial participation of the private sector in such an entity, and increased private participation over time

Option 1 Identify several transactions that could be attempted in Honduras to raise market funds and evaluate the feasibility of proceeding with one or more of them Examples might include another municipal bond issue, various privatization activities, a bond issue to community members, an issuance of notes, a larger bank financing, a bank syndication or a private placement through a fiduciary

Option 2 Create a joint public-private task force to act as a "credit committee" for evaluating municipal and potential privatization projects in need of financing, in an effort to encourage to approaches and to expand the involvement of the private sector in the resolution of municipal financing constraints Once reviewed, this group of projects could be marketed as "investment opportunities" to private financial institutions and other investors

Option 3 Provide additional resources for assisting municipalities in identifying and carrying out appropriate privatization activities This could take the form of technical assistance to municipalities, support for specific transactions, public information related to privatization and labor concerns, etc

Option 4 Raise and place a pool of funds from one or more concessionary sources in an institution whose expressed purposes would be its own financial sustainability and co-financing of municipal loans with the private sector It might lend directly to municipalities or serve as a second-tier lender to banks Ideally, this entity might have the objective of eventually becoming a private sector institution itself

Option 5 Request CABEI to expand its PROMUNI program into Honduras Two of the aspects of the PROMUNI program that have been especially successful in Guatemala and Costa Rica are also critical development areas for Honduras as well, namely, familiarization of the financial sector with the financing requirements and capacities of the municipal sector and the need to ıncrease the abılıty of munıcıpalıtıes to prepare project proposals that are acceptable to the prıvate sector

1 6 Support Efforts to Improve and Enforce the Legal/Regulatory Framework

Whıle some ımprovements ın the legal/regulatory framework are approprıate, ımplementıng benefıcıal elements of the exıstıng framework ıs also ımportant AMHON advocates effectıvely on may elements of the exıstıng framework, but those actıvıtıes mıght be bolstered by support from the polıcy forum proposed below

Optıon 1 Reform elements of the munıcıpal law that wıll allow strengthenıng of the munıcıpal tax base The most crıtıcal steps ınvolve ımprovıng the real property tax, for ınstance allowıng munıcıpalıtıes to ıncrease the ıncıdence (mıllage) applıed durıng the off years, ın order to adjust revenues for ınflatıon The varıous exoneratıons and exceptıons granted concernıng the real property tax that have been allowed sınce passage of the Munıcıpal Law (e g , Decree 124-95) should be revıewed and perhaps rolled back Lıkewıse, exoneratıons to the tax on ındustry, commerce, and servıces should be revıewed and possıbly phased out

Optıon 2 Encourage full complıance wıth the ıntergovernmental revenue transfer and reexamıne ıts structure Local governments are penalızed by the faılure of central government to transfer to munıcıpalıtıes the full transfer revenues stıpulated by law (5% of natıonal tax ıncome) The advocacy for thıs complıance may need to be made more effectıve The formula for transferred resources to munıcıpalıtıes should be consıdered for revısıons so that ıt would better a) reward munıcıpalıtıes that ımprove theır local revenue collectıons and b) redıstrıbute some funds to the poorer munıcıpalıtıes, ı e , those that are less able to mobılıze theır own resources

Optıon 3 Improve the regulatory framework for tarıff settıng The role of the CNSSP ın regulatıng munıcıpal servıces should be clarıfıed, thıs authorıty may not be needed or local governments mıght request a seat on the board Assumıng ıts role remaıns ın place, CNSSP ought to consıder developıng a strategy for ıncreasıng tarıffs to reflect full costs over a perıod of tıme At the same tıme, optıons for subsıdızıng those households that are truly unable to pay the full costs of basıc servıces should be ıdentıfıed and ımplemented Fınally, servıce provıders need legal changes that wıll allow them to ındex theır tarıffs to ınflatıon, wıthout havıng to waıt for Commıssıon approval

Optıon 4 Identıfy resources for a legal revıew of constraınts to market-based munıcıpal fınance for the munıcıpal sector and use ıt to help educate mayors and others regardıng the ımportance to them of polıcy decısıons ın other areas of the economy

1 7 Promote Development of an Integrated Munıcıpal Fınance Framework

The publıc-prıvate forum dıscussed below wıll help brıng to lıght current actıvıtıes ın munıcıpal fınance and facılıtate a dıscussıon among many players on the need for an expanded system Separate, more dırected actıvıtıes are also needed to encouragıng the development of a munıcıpal fınance framework that would guıde future reform and development The forum could provıde technıcal leadershıp, polıtıcal leadershıp and polıtıcal support to the process, an admınıstratıve and/or oversıght functıon may be needed to ımplement the fınance framework ın a coordınated fashion Substantive central government involvement in the development of this framework should be considered a fundamental requirement

Option 1 Donors, including USAID, could introduce the need for a finance strategy in policy discussions with the GOH This approach would require a leadership response from the central government, perhaps the Ministry of Government (*Ministerio de Gobernacion*)

Option 2 Existing NGOs, such as AMHON and FUNDEMUN, could coordinate development of the framework with the government, perhaps with financial assistance from donors

Option 3 The public/private forum discussed below would carry out development of the framework, based on a commitment from the government to participate in a substantive manner The concern would be whether this entity (especially if it is informally constituted) would have the credibility necessary to influence the necessary policy decisions

1 8 Create a Public-Private Forum for Finance Policy Dialogue

The purpose of this activity is to promote the concept of municipal finance as a system with many different players and elements, and to create a forum for the dialogue that can lead to articulation of a municipal finance framework The participants need to be all those with an interest in the development of the system, including the Honduran public sector (central and municipal government, etc) and private sector (banks, consultants, investors, etc) and donors

Option 1 Plan and hold a workshop to evaluate the recommendations made in this report and to identify priority short-, medium-, and long-term strategies The list of those interviewed for this report could form the basis for an invitation list, however, additional private sector participants should be identified and encouraged to attend

Option 2 Create a casual forum that holds periodic seminars or sponsors speakers on the topic of municipal finance This might be a bimonthly pay-your-own-way luncheon, sponsored by a different organization each time, with invited speakers both local and from the outside addressing topics related to innovations in municipal finance and privatization Topics might include San Pedro Sula's municipal bond, local market privatization projects, PROMUNI, leasing and its relevance to the municipal sector, financial software in use by municipalities, etc

Option 3 Create a more formal committee or organization, either independent or under the auspices of an existing organization or agency, that is charged with development of an expanded system

Option 4 Identify an existing organization to organize this initiative, making an effort to make the discussions as inclusive as possible One candidate would be AMHON, however, the activity must be perceived as being as politically neutral as possible

1 9 Develop a Monitoring Mechanism for Municipal Finance System

It is recommended that a monitoring mechanism ("report card") for the municipal finance system be developed for Honduras This recommendation reflects the assumption that indicators both help track progress, and also actually influence where progress is made Identifying those aspects of the municipal finance system that are of the most concern to those affected by it will focus attention and resources on those elements and help to move them forward The initial report card could identify the critical elements and related indicators and set goals A baseline grading of the various elements should also be done Subsequent annual reports could track progress, update the grades and set new goals, as appropriate

Elements might include a) the total pool of resources available from an identified group of sources, b) the number of loans, c) the size of loans, d) the percent with a match and the level of the match, e) the number of municipalities borrowing, f) the number of banks lending, g) the number of beneficiaries, h) the progress of policy reforms, etc

Option 1 Together, the GOH, USAID, and other donors could appoint a small public-private commission to provide expert input and oversight to a technical team that would develop the original indicators and report card and issue it with some fanfare Annually, for the first two years, this report card would be updated with prefunded resources, until another local source of funds is identified

Option 2 The GOH, USAID, or another donor could give resources to one of its existing counterparts (AMHON or FUNDEMUN) to develop and issue a report card and update it annually

Option 3 The development of the report card could be an activity of the forum proposed in Section 1 1 This would raise the visibility of the forum and ensure that private sector perspectives were included

2 Areas for Action — Short-, Medium-, and Long-Term

The following table organizes the proposed options into those that could be implemented in the short term (1-2 years), medium term (2-5 years), and long term (5 to 10 years) Some of these options would continue to be carried out and would likely have ongoing impact throughout the 10-year period Others, even if begun immediately, might have limited impact until later in the 10-year time period A column also shows expected results from the listed interventions

Areas for Action — Short-, Medium-, and Long-Term

		Time Frame for Implementation			Time Frame for Results		
	Proposed Action	Short Term (1 2 years)	Medium Term (2 5 years)	Long Term (5 10 years)	Short-Term (1 2 years)	Medium Term (2 5 years)	Long-Term (5 10 years)
1	**Improve Creditworthiness**						
	Municipal Development Indicators						
	Donor Coordination						
	Assist Smaller/Poorer Municipalities						
2	**Expand Information**						
	Financial Operations						
	Develop Credit Scoring System						
	Cost Recovery Lessons Learned						
3	**Expand Technical Assistance**						
	Expand Training and TA Resources						
	Expand Scope of Training Activities						
	TA Standards/Encourage Competition						
4	**Expand & Improve Allocation of Funding**						
	Public Private Coordination on Policy						
	Inventory Successful Government Support						
	Private Sector Leadership on Policy						
5	**Support Innovation in Financing**						
	Identify Pilot Financing Projects						
	Joint Public Private Credit Committee						
	Support Privatization Initiatives						
	Raise Additional Concessionary Fund						
	Initiate PROMUNI						
6	**Provide Legal/Regulatory Support**						
	Strengthen Tax Base						
	Improve Intergovernmental Transfer						
	Improve Regulation of Tariff Setting						
	Legal Issues Paper for Municipal Sector						
7	**Develop Policy Framework**						
	Donors Work with GOH						
	NGO Develops Framework						
	Forum Takes Lead						
8	**Organize Public Private Dialogue**						
	Workshop to Evaluate Assessment						
	Casual Forum						
	Formal Committee						
	Existing Organization						
9	**Develop Report Card**						
	Indicators Developed by Commission						
	Indicators by Existing Organization						
	Indicators Developed by Forum						

ANNEXES

Annex 1
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Annex 2
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Annex 3
Financial Data on FHIS Programs

Table 1
FHIS Income by Financing Source, 1990-96
in thousand Lempira

Sources	1990	1991	1992	1993	1994	1995	1996	Total	% Total
USAID	19 553	24 277	1 474	18 118	13 898	11 278	27 441	116 039	8 17
World Bank	0	54 240	55 371	36 563	17 443	74 803	195 056	433 476	30 50
IDB	0	0	20 537	124 070	46 711	51 125	116 753	359 196	25 28
KfW	0	9 302	41 573	52 123	35 568	5 263	15 636	159 465	11 22
OPEC	0	0	0	0	0	22 274	19 591	41 865	2 95
National	10 092	11 293	44 458	41 642	26 227	41 000	50 000	224 712	15 81
Others	6 732	5 434	11 797	8 297	22 461	16 452	15 096	86 269	6 07
Total	36 377	104 546	175 210	280 813	162 308	222 195	439 573	1 421 022	
Exchange Rate (L/$)	4 11	5 32	5 5	6 47	8 41	9 47	11 71		
Total US$ (000)	8 851	19 652	31 856	43 402	19 299	23 463	37 538	184 062	
USAID $ (000)	4 757	4 563	268	2 800	1 653	1 191	2 343	17 575	

Table 2
Distribution of FHIS Projects by Applicant and Average Project Size, 1990-96
in thousand Lempira

Description	Amount	%	Number of Projects	%	Average (L)
Municipalities	907,586	72 2	6,015	74 3	150,887
Governmental Organizations	155,445	12 4	603	7 4	257,786
Patronage	69,178	5 5	631	7 8	109,632
School Directorates	52,170	4 1	344	4 3	151,657
NGOs	41,842	3 3	268	3 3	156 127
Religious Institutions	14,011	1 1	126	1 6	111,198
Special Groups	5,094	0 4	37	0 5	137,676
Hospitals & Centers	4,272	0 3	15	0 2	284,800
Others	7,671	0 6	55	0 7	139,473
Total	1 257 269	100 0	8 094	100	
Average Project Size (L)					155 333

Table 3
FHIS Investment per Sector, 1990-97
in thousand Lempira

	1990	1991	1992	1993	1994	1995	1996	1997	Total
Education	3 483	83 752	104 434	128 049	23 583	112 894	155 384	173 681	785 260
Water and Sanitation	434	7 113	22 820	22 177	13 602	13 973	98 027	36 504	214 650
Health	736	20 048	14 501	37 365	21 283	28 657	36 340	55 478	214 408
Municipality	6 496	16 919	21 073	19 231	6 502	17 994	52 607	21 250	162 072
Social Assistance	547	6 640	5 308	6 422	153	11 097	12 014	2 480	44 661
Environment	414	474	542	1 638	319	452	751	3 994	8 584
Total	12 110	134 946	168 678	214 882	65 442	185 067	355 123	293 387	1 429 635
Exchange Rate	4 11	5 32	5 50	6 47	8 41	9 47	11 71	13 20	
US $	2 946	25 366	30 669	33 212	7 781	19 542	30 326	22 226	172 070

Table 4
FHIS Investment Distribution by Poverty Level, 1990-96
In % and thousand Lempira

Poverty Level (By Department)	Poverty Distribution	% of Investment Per Quintile		Total (L 000)
		FHIS I	FHIS II	
Very Bad	20%	19%	26%	299
Bad	21%	17%	19%	256
Deficient	24%	22%	23%	284
Subtotal	**65%**	**58%**	**68%**	**839**
Regular	26%	32%	26%	312
Acceptable	9%	10%	6%	106
Subtotal	**35%**	**42%**	**32%**	**418**
Total (%/L 000)	**100%**	**L 531**	**L 726**	**L 1,257**

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Table 5
USAID Funding to FHIS for Honduran Municipal Development, 1990-98

	Lempira	US$
FHIS I	75,512,100	
FHIS II	56,814,969	
Total 1990 Funding[17]	*132 327 069*	*14 500,000*
Grant Funds related to MDP	151,440 269	10,586,527
BCIE I (HG-006)	117,000 000	9,000,000
BCIE II (HG-006)	63,700,000	4,900,000
Child Survival Grant	42 250,000	3,250,000
Total Current Funding[18]	*374,390,269*	*27 736,527*
Total	506,717,338	42,236 527

[17] FHIS '1996 Progress Advance Report, Tegucigalpa, March 1997

[18] USAID Worksheet, "Programa de Desarrollo Municipal, Componente de Infraestructura," July 8,1997

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Annex 4
Potential New or Modified Roles for USAID/Honduras

The terms of reference for the assessment of the municipal finance system state the intention of USAID to carry out a participatory process for review of the options that emerged from the assessment and also request recommendations for action by USAID in the short, medium, and long term While the audience for this document is therefore broader than USAID alone, this Annex addresses specific actions that USAID could take on its own initiative to promote the development of a more sustainable municipal finance system in Honduras

In addition to the assessment, the scope of work requests assistance in two areas 1) development of a near-term strategy (1 to 3 years) for providing continuous financial resources to municipalities after the HG funds are exhausted and 2) development of a proposal for a participatory process that will lead to design of a municipal infrastructure finance framework for sustainable long-term financing

The Role of USAID in Supporting Municipal Finance Expansion

As discussed in this section, and elsewhere in the report, opportunities for USAID to address the issues discussed in this assessment exist in three components of its development activities in Honduras

- municipal development and related institutional development,
- policy dialogue with the GOH and others, and
- implementation of the Housing Guarantee program

USAID has enjoyed considerable credibility in many developing countries in its work on municipal finance, partly because of the well-known municipal finance experience of the United States [1] For that reason, USAID is encouraged to continue to provide leadership on the issue of municipal finance in Honduras, even though certain aspects of the U S system may be inappropriate or difficult to apply

The current municipal development activities of USAID/Honduras are appropriate and effective interventions for strengthening the municipal sector Their value will be even more evident as opportunities for municipal financing grow in Honduras, since the involved municipalities should be in a favorable situation to ask for credit USAID is encouraged to continue these activities to the extent possible over the next several years Expanding the program to include a larger number of municipalities should be pursued if possible, but the most important accomplishment for the entire sector in the longer run is to have a core group of creditworthy municipalities that can reorient the thinking of the financial sector and others about the capacity of the municipal sector Other roles that seem to be especially appropriate in the municipal development context, as suggested by this assessment, include

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[1] See "Municipal Bond Market Development in Developing Countries The Experience of the U S Agency for International Development " by Priscilla M Phelps for a discussion of eight countries where USAID has carried out municipal finance activities

- encouragement of more, improved, and standardized information reporting wherever possible,
- support of development of a credit rating system for municipalities, acceptable to all public and private sector funders,
- ensuring that prices for technical services to municipalities are set on a market basis whenever possible, encourage competition among providers while maintaining quality, and
- identification and assistance in initiating pilot projects to test feasibility of new approaches to municipal financing within the context of ongoing activities

The most critical role for USAID at this time is its policy leadership on municipal finance In Part III, Section 1, a number of potential roles for USAID are specifically proposed, many of which could be categorized as policy leadership Examples include the commissioning of this paper and the related workshop and helping establish the public-private policy dialogue In the workshop, it will also be important to discuss the question of the most effective role for USAID on this issue with the participants Specific roles USAID should consider, based on the assessment, include the following

- Take the lead to establish the public-private policy dialogue
- Expand donor coordination on municipal finance
- Ensure USAID consistency on issues related to municipal finance, such as macroeconomic policy and financial sector reform
- Advocate in policy forum for development of a national municipal finance framework
- Carry out specific policy or implementation studies, such as
  - Legal constraints to municipal finance
  - Identification of innovative joint public/private financing approaches
  - Expanding cost recovery and the role of the *contribuciones por mejores*
- Identify resources for innovative pilot projects
- Encourage financial sector involvement in system development
- Assist municipal officials in advocating for market reforms to allow for expanded municipal lending
- Assist AMHON and other counterparts to the MDP in understanding the issues addressed in this assessment

Near-Term Strategy for Provision of Financial Resources

Currently, USAID funding provided to the FHIS from the USAID Housing Guarantee program and loaned to municipalities at below-market rates is the major source of credit available to them A group of municipalities has been identified as the recipients for the last round of funding under the program in 1998 However, USAID is concerned that following this round, no additional source of credit will be available to municipalities The findings of the assessment generally confirm this expectation for the short term, unless specific measures are taken

As shown in this report, the financing requirements of the municipal sector are far in excess of what is currently available and of what can be raised from the public sector or from donors in

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the short term However, it will be necessary for these sources to help fill some part of the funding gap The challenge will be to do so in a way that encourages the growth of resources in the overall system The second necessary source is the private market, and immediate measures should be taken to expand its role in the system The way in which the concessionary funding is provided to municipalities could help determine whether private funding expands appreciably The success of other measures recommended, such as the development of a credit scoring system, will also effect the level of private sector financial commitment

Discussions with USAID held during the assessment period focused on how the current round of FHIS loans could be structured to support the development of the system being proposed Decisions regarding the allocation of the available funds were found to be nearly complete, based on judgments of USAID employees concerning municipal need and desire to arrive at a fair allocation of available resources among participating municipalities (rather than on creditworthiness, although a feasibility study is carried out in connection with each project) However, options for expanding the available resources in the short term include some related to the ongoing provision of the HG resources Several measures are possible to support further growth of the system in the short run, including the following

- **Maximize the extent of private financing in each FHIS loan**
  Currently, loans given by the FHIS using USAID resources require a "counterpart" (partial match of funding) from the municipality, but the balance is generally funded with Municipal Development Program resources It is recommended that each loan be reviewed for components, such as equipment purchases, that could be financed as shorter-term loans by a local bank The allocation plan of USAID could then include these other sources of funds to the extent the are available and affordable for the municipalities It will be necessary to devise a project worksheet that allows for the inclusion of other sources of funds

- **Create a revolving fund using HG/FHIS resources**
  Currently, loan repayments for the HG loans are made to the Ministry of Finance and are assumed to be used to repay the U S government loan Loan terms to municipalities closely match those of the U S government loan, with similar grace periods However, the potential for shortening the term of loans so that at least some of the resources could be reloaned has apparently not been considered, but should be

  One of the difficulties in identifying strategies to bridge the current concessionary sources, and those that might in time be available in the private market, is the extent of the concessionality of the funds that are currently provided This concessionality takes the form of lower interest rates (10% versus up to 30% in the market over the last few years), longer loan terms (20 years versus a maximum of 2 to 3 years), and grace periods on repayment of principal (up to 10 years on some USAID-funded loans currently outstanding) These terms raise the expectations of municipal officials unrealistically and make it extremely difficult for a market-based provider of credit to offer any loans that the municipalities consider competitive To whatever extent USAID could break out of this pattern in its loan terms, the better it will be for later system development

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- **Collaborate with other donors to continue USAID's funding role with the FHIS in the short term, perhaps with less concessionary loan terms**

  While other financing mechanisms are being developed, USAID should approach other donors to take over the role being played by USAID in providing funds to the FHIS for municipal projects Both the IDB and the World Bank (and perhaps others) are considering making loans for the municipal sector in Honduras Savings of both cost and time could be realized if one of them would step into USAID's role to provide funding for the next 2 to 3 years at least, ideally under conditions closer to market conditions This approach would provide continuity to municipalities and allow design resources to be spent in creating a longer-term mechanism that might take 1 to 2 years to create and another year to start up

- **Negotiate with CABEI for a start-up of PROMUNI activities in Honduras**

  While not itself a sustainable mechanism, the PROMUNI program has broken ground for municipalities with the financial sector in Guatemala and Costa Rica USAID should discuss with CABEI the potential for opening the PROMUNI program in Honduras over the next year With two country programs well established, certain time savings should be possible in orienting IFIs and establishing application procedures for municipalities Also, peer training between municipal officials in Honduran and those in Guatemala or Costa Rica who have participated in the program could be extremely instructive for all involved

Municipal Finance Workshop

The next recommended step for USAID is to hold a workshop to review the ideas proposed in this report The recommended attendee list would be those interviewed for this assessment, with the addition of additional financial sector and institutional finance representatives, if possible The number of attendees should be small enough to allow for a participatory meeting, but large enough to include all the critical interest, perhaps 30 participants

It is recommended that a second draft of this paper, or of the most important sections, be translated and circulated to this expanded group and that a meeting with them be held within one month for up to one full day It could include speakers on specific issues from among those participants already familiar with the issues being addressed, some smaller meetings on specific issues, and time for plenary sessions where general issues could be addressed and differences of opinion presented

The objectives would include feedback on the report that could be incorporated in a final version and proposals and preliminary plans for follow-up activities The responses and proposals could also be included in the final report

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