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Reforming Public Investment and the Infrastructure Sectors
A Joint World Bank and Inter-American Development Bank Study

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ACRONYMS AND ABBREVIATIONS

AGSAC Agricultural Adjustment Credit
CABEI Central American Bank for Economic Integration
CNEE National Commission for Electric Energy
CNSSP National Commission for the Supervision of Public Services
DGAC Directorate General for Civil Aviation
DGCCA Directorate General of Roads and Airport Maintenance
DGCA Dirección General de Tributación (General Directorate of Taxation)
DGCMCA Dirección General de Mantenimiento de Caminos y Aeropuertos
ENT National Ports Enterprise (Empresa Nacional de Puertos)
ESAC Energy Sector Adjustment Credit
ENEE Empresa Nacional de Energía Eléctrica (National Electric Energy Enterprise)
FHIS Fondo Hondureño de Inversión Social (Honduran Social Investment Fund)
FHI Ferrocarril Nacional de Honduras
FOSOVI Fondo Social de Vivienda (Social Housing Fund)
HDM Highways Design and Maintenance Model
HONDUTEL Empresa Hondureña de Telecomunicaciones (Honduran Telecommunications Enterprise)
ICOR Incremental Capital Output Ratio
IDA International Development Association
IDB InterAmerican Development Bank
IMF International Monetary Fund
IMPREMA Pension Funds for Civil Servants and Teachers
INFOP Instituto de Formación Profesional (Institute for Professional Training)
INJUPEMP Instituto Nacional de Jubilaciones y Pensiones de Empleados del Poder Ejecutivo (National Institute of Retirees of the Executive Power)
MTEF Medium Term Expenditure Framework
PE Public Enterprise
PFP Policy Framework Paper
PI Public Investment
PIP Public Investment Program
PIR Public Investment Review
PRAF Programa de Asignación Familiar (Family Income Support Program)
SANAA Servicio Autónomo Nacional de Agua y Alcantarillado (National Autonomous Water and Sewerage Service)
SDSP Ministry of Health
SPS San Pedro Sula
SCHP Ministry of Finance
SEC Ministry of Economy and Commerce
SECOPT Secretaría de Comunicaciones, Obras Públicas y Transporte (Ministry of Communications, Public Works, and Transport)
SECPLAN Ministerio de Planificación (Ministry of Planning)
SHCP Secretaría de Hacienda y Crédito Público (Ministry of Finance and Public Credit)
SISPU Sistema de Inversiones del Sector Público (Public Sector Investment System)
UNAH Universidad Nacional Autónoma de Honduras (National Autonomous University of Honduras)
UNICEF United Nations Children's Fund
UNDP Programa para el Desarrollo de las Naciones Unidas (United Nations Development Program)
UPNFM Universidad Pedagógica Nacional Francisco Morazán
WDR World Development Report
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PREFACE

This report is prepared by the World Bank and the IDB as a contribution to their ongoing policy dialogue with the Government of Honduras. The policy dialogue of the World Bank with the Administration of President Reina began in January 1994 with a presentation to the members of the transition team of the World Bank's Country Economic Memorandum/Poverty Assessment (CEM). The main macroeconomic message of that report was the need to restore the fiscal equilibrium lost during the presidential elections of 1993. The CEM was published in English in November 1994 and later, at the request of the Government, it was translated into Spanish to encourage dissemination of its results in Honduras. During early 1994, the economic dialogue continued based on discussions of the Government's Policy Framework Paper (PFP), of the results of supervision missions of the Agricultural Sector Adjustment Credit (AGSAC) and the Energy Sector Adjustment Credit (ESAC), and of documents produced in preparation for a forthcoming Public Sector Modernization Credit.

The policy dialogue of the Inter-American Development Bank with the Reina Administration was initiated at the beginning of the Administration through the supervision of sectoral reform projects in energy, agriculture, and finance. This dialogue was continued through several missions leading to the Programming Mission and the presentation of IDB's Country Paper to the authorities in mid-1995. IDB has also been involved in policy dialogue with the Government through the preparation of the programs for the Reform of the Public Sector, the Reform of the Water and Sanitation Sector, the Reform of the Judiciary, the Reform of the Legislative, and the Reform of the Tax Administration.

In early 1994, it became clear that one of the main challenges to be faced by the new administration was improving the management of public investment and the provision of infrastructure services. The Government and the IMF requested that the World Bank and IDB undertake a study to make recommendations in this area.

Preparations for the study were supported by the Economic Cabinet and particularly by SECPLAN which prepared a Public Investment Program document especially for use of the mission. The IMF supported the effort by making available some of its data on the evolution of public investment. Task managers of sector projects financed by the World Bank and the IDB also contributed to the preparation of the mission, and later provided comments on early drafts of this report.

The report is based on the findings of a visit to Honduras in December 1994 and its results were updated during subsequent visits. An initial draft of this report was prepared in the field in December 1994 and discussed with the Authorities at that time. An advanced draft was presented to the authorities in June 1995. Discussions of the draft report were held individually with each of the sector agencies and a general presentation was given to the Economic Cabinet. The conclusions reached during those discussions are reflected in this report.

In addition to this report, team members prepared sector reports discussing in greater detail the issues for the following sectors: Roads; Ports and Airports; Telecommunications; Electricity; Water and Sanitation; Investment Planning and Budgeting; and Social Sectors. After incorporating comments from the task managers responsible for the respective sectors in both banks, the reports were sent to the Government in January 1995. Additional copies of these reports can be obtained from the World Bank or IDB.
EXECUTIVE SUMMARY

1. High levels of public investment (PI), low levels of savings and an inefficient system of regulation for the provision of infrastructure services constitute a key obstacle to macroeconomic stability and growth in Honduras. The main source of macroeconomic instability is a structurally high fiscal deficit, which reached over 10 percent of GDP in 1993 and was reduced to 7.5 percent of GDP in 1994 with the implementation of courageous measures by the Administration inaugurated in January 1994. Public investment and debt service for debt contracted to finance past investment constitute over half of public expenditures. The new Administration found its hands tied with rigid investment contracts signed by the previous Administration and was forced to cut recurrent expenditures, postpone desired investments in the social sectors and increase taxes to begin to bring the fiscal deficit under control. An inefficient system of regulation adds to the fiscal burden created by this investment by further draining the public finances to compensate for incomplete cost recovery by the public enterprises in charge of providing the main infrastructure services. Over two thirds of public investment is implemented by five agencies: The Ministry of Communications, Public Works and Transportation (SECOPT) and the main four public enterprises (PEs). Public finances will not be brought under control until the sectors where the four PEs provide services are reformed and until the reform process initiated in SECOPT in 1991 is completed.

2. In addition to its impact on macroeconomic instability, there are important macroeconomic and microeconomic inefficiencies associated with PI which constitute an obstacle to economic growth. The macroeconomic inefficiencies consist of a crowding out of private investment and a growing ineffectiveness of investment in generating growth. Public investment has grown every decade since 1950 as a proportion of GDP and as a share of total investment. Until the 1970s, the growth of public investment accompanied growth in private investment. From 1980 on, the growth of public investment has occurred at the expense of private investment levels. The growing ineffectiveness of investment is reflected in the more than doubling of the ICOR from 1950-79 to 1980-94.

3. The provision of infrastructure services is characterized by lack of competition and inefficient regulations which have led to important microeconomic inefficiencies: (i) low coverage -- usually excluding the poor; (ii) poor quality of service and lack of enforcement of safety and environmental regulations; (iii) distortionary tariffs; (iv) lack of maintenance; and (v) the unsustainable use of foreign credits to finance the maintenance of the road network.

4. Public investment is high because the state has replaced private investment by monopolizing key economic areas and by regulating these areas in ways that restrict or prevent private participation and competition. The poor performance of the PEs in infrastructure provision can be attributed mainly to the overextended role of the state and the lack of competition in the provision of infrastructure services. The public sector is in control, to varying degrees, of all four of the major functions in infrastructure provision: ownership, operation, regulation, and sectoral policy setting, monitoring and control. There is little competition in the provision of infrastructure. Telecommunications are served by public monopolies. Electricity and railways are sectors where private providers have some participation, however the public enterprises dominate the supply with the private operators operating only at the fringe of the market. About half of the services in ports are provided directly by the traders, however important inefficiencies remain for other users of the port, partly related to an inefficient system of regulation. While some horizontal unbundling has taken place in the case of water and sanitation services by the decentralization of some of the services to some municipalities and the development of private and community providers, the sector has not developed a competitive structure. Transport services is a sector where divisibility could allow the development of a textbook case of competition. However, licensing of urban and intercity transport services has created an oligopolistic structure behind protected markets.

5. The role of the state is yet to be redefined in a way that allows the economy to rely more on the market for efficiency and on the private sector for financing. Numerous initiatives for privatization or other forms
A joint World Bank/IDB Study of participation in the provision of infrastructure services are being considered by the authorities and interest in these initiatives is developing in the private sector. There is a Presidential decision to privatize telecommunications, the new electricity law (despite some important flaws discussed in the main report) opens the way for the private sector in new generation and distribution, there is talk of concessioning/privatizing several services in ports, airports, roads, railways and water and sanitation. The private sector has also shown interest in some of these possibilities, although the terms in which this interest would materialize remain unknown. Two joint World Bank/IDB adjustment operations are under preparation, to support these initiatives. A Public Sector Modernization Credit will support the privatization of HONDUTEL and the corporatization and concessioning of airports. A Water and Sanitation Adjustment Credit will support the decentralization and reform of this service. A Transport Sector Rehabilitation Credit is providing technical assistance for the reform of ports and airports.

6. For 1995, the Government aimed at raising the share of the social sectors in the budget to 35 percent of public investment. This target was surpassed in the 1995 budget where the share of the social sectors in public fixed investment is 38 percent. Furthermore, for 1995 Congress has approved a budget that allocates 56 percent of total primary (i.e. non-interest) expenditures to the social sectors. Despite the large fiscal allocation to the social sectors, there remains a widespread perception, that includes Government officials, public opinion and donor agencies, that not enough is being done for the poor through the PIP and the economic policy framework. Two reasons explain this perception. First, the Government needs to develop a strategy explaining how poverty reduction is to be achieved. There is no statement that explains the Government's strategy for growth and poverty reduction, identifying the links between the two. Lacking such a strategy, Government officials place excessive emphasis on direct interventions, subsidized credit, price controls and control of the tariffs of public enterprises. The lack of an explicit strategy for poverty reduction is partly due to lack of information and analysis about who the poor are and how they can be reached through public policy and investment. Second, most of the investment in the social sectors is not reaching the poor because of its bias in favor of the middle classes and because of inefficiencies in the way public services are provided. In 1994, 73 percent of the investment in the social sectors was assigned to areas that have a very limited impact on the welfare of the poor: housing financed by the pension funds, water and sanitation investments by SANAA and higher education. Changing this bias will require drastic changes in the composition of new investment and in the operation of the social sectors.

7. Public expenditures in the social sectors, at almost 9 percent of GDP, are high relative to income by international standards. The main challenge at present is in the education sector, where despite a notable expansion of coverage at the primary level to its current level of 86 percent, Honduras continues to lag behind comparable countries in terms of educational achievement, even among the young who benefited from the recent expansion of coverage. Given the Government's fiscal constraints, improving the quality of social services will depend on achieving greater efficiency rather than on increasing expenditures.

8. A change of paradigm is needed in primary education, moving away from an emphasis on expansion to one of increased quality. The Ministry of Education, with support from an IDA credit is beginning implementation of the new paradigm of improving quality. Quality of education is strongly correlated with non-salary recurrent expenditures (e.g. textbooks and training). Although the budgetary allocation to education, at over 4 percent of GDP, is high by international standards, non-salary current expenditures are under 4 percent of the sector budget and have fallen by 20 percent since 1980. This decrease was due to the need to expand coverage, which required a larger allocation to the construction of new infrastructure and the hiring of additional teachers. It was also due to the rapid increase in the weight of transfers to higher education in the sector budget. Also, administrative costs per student have more than doubled since 1980. As the budgetary allocation to the sector is already high, increased quality requires savings and a reallocation of sector resources. Savings could be obtained by reducing administrative costs and by reducing the high rate of student repetition. The Government should also explore the (admittedly politically difficult) possibility of reallocating resources from higher education to primary education.