

FINAL REPORT

**THE ROLE OF MUNICIPALITIES IN THE
RECONSTRUCTION OF HONDURAS:
AN ASSESSMENT OF THE
IMPACT OF HURRICANE MITCH**

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TABLE OF CONTENTS

Abstract

List of Acronyms and Abbreviations

Executive Summary

1	Introduction and Purpose	1
1.1	Purposes	1
1.2	Work Plan	2
1.3	Limitations of the Study.....	2
1.4	Report Outline.....	2
2	Background: Municipal Development, 1990–1999	3
3	Pre-Mitch Public Finance Setting and Intergovernmental Fiscal Relations.....	5
3.1	Overview.....	5
3.2	Municipal Responsibilities and Functions	6
3.3	Sources of Municipal Revenue	6
3.4	Municipal Credit	9
3.5	Deficiencies in Municipal Financial Systems.....	9
3.6	Transparency and Flow of Funds for Municipal Development	10
3.7	Municipal Financial and Administrative Capacity and FHIS Grading System.....	12
4	Case Studies of Honduran Municipalities	12
4.1	Catacamas	13
4.2	Choluteca	17
4.3	El Progreso.....	22
4.4	La Ceiba.....	24
4.5	La Lima.....	27
4.6	Small, Remote Municipalities.....	28
5	Post-Mitch Reconstruction Plans	29
5.1	National Reconstruction Plan	29
5.2	Municipal Reconstruction Plans	29
5.3	USAID and Other Donor Support Plans.....	30
5.4	Costs.....	30
6	Summary of Findings	31
6.1	National-Level Impact of Mitch	31
6.2	Municipal-Level Impact of Mitch.....	32
7	Summary of Issues and Recommendations	33
7.1	Decentralization Policy	33
7.2	Preparation of National Reconstruction Plan.....	34
7.3	Funding Channels and Implementation of Reconstruction Projects.....	34

7.4 Grading System for Municipal Administrative Capacity	35
7.5 Municipal Financial Systems	35
7.6 Municipal Debt	36

Attachment A. List of Contacts

Attachment B. References

ABSTRACT

USAID/Honduras is assisting the government and the people of Honduras with their efforts to recover from the effects of Hurricane Mitch, which struck the country during the last days of October 1998. The immediate relief phase has been completed, and the focus has now shifted to the recovery and reconstruction phases. For USAID/Honduras and the USAID/Washington Office of Environment and Urban Programs, ICMA led a four-person team to assess the impact of Hurricane Mitch on the financial and administrative capacity of Honduran municipalities.

The purposes of the study were to describe the short- and long-term impact of Hurricane Mitch on the financial and administrative capacity of the municipalities in Honduras; identify specific issues and constraints that affect the capability of the municipalities to carry out their responsibilities in the reconstruction process; and recommend concrete solutions to the problems identified during the study.

The fieldwork took place between March 15 and March 31, 1999, in Honduras. The study team met with national level agencies of the GOH, international donors, and nongovernmental organizations (NGOs) in the capital of Tegucigalpa and then visited five of the municipalities affected by Hurricane Mitch to prepare case studies. In addition, team members interviewed mayors from four small, remote Northeast Coast municipalities during their visit to Tegucigalpa.

LIST OF ACRONYMS AND ABBREVIATIONS

AMHON	<i>Asociación de Municipios de Honduras</i> (Association of Honduran Municipalities)
BANMA	<i>Banco Municipal Autónomo</i> (Municipal Development Bank)
CABEI	Central American Bank for Economic Integration
CODEM	<i>Comité de Emergencia Municipal</i> (Municipal Emergency Committee)
ENEE	<i>Empresa Nacional de Energía Eléctrica</i> (National Energy Company)
ESAF	Enhanced Structural Adjustment Facility
FHIS	<i>Fondo Hondureño de Inversión Social</i> (Honduran Social Investment Fund)
FUNDEMUN	<i>Fundación para el Desarrollo Municipal</i> (Honduran Foundation for Municipal Development)
GOH	Government of Honduras
GDP	Gross Domestic Product
IDB	Inter-American Development Bank
ICMA	International City/County Management Association
IMF	International Monetary Fund
NGO	Nongovernmental organization
OFDA	Office of Foreign Disaster Assistance
SANAA	<i>Servicio Autónomo Nacional de Acueductos y Alcantarillados</i> (National Water and Sewer Agency)
SDR	Special Drawing Rights
SOPTRAVI	<i>Servicio Nacional de Obras Públicas, Transporte y Vivienda</i> (National Agency for Public Works, Roads, and Housing)
USAID	U.S. Agency for International Development

EXECUTIVE SUMMARY

USAID/Honduras is assisting the government and the people of Honduras with their efforts to recover from the effects of Hurricane Mitch, which struck the country during the last days of October 1998. The immediate relief phase has been completed, and the focus has now shifted to the recovery and reconstruction phases. For USAID/Honduras and the USAID/Washington Office of Environment and Urban Programs, ICMA led a four-person team to assess the impact of Hurricane Mitch on the financial and administrative capacity of Honduran municipalities.

The purposes of the study were to:

- Describe the short- and long-term impact of Hurricane Mitch on the financial and administrative capacity of municipalities in Honduras.
- Identify specific issues and constraints that affect the capability of the municipalities to carry out their responsibilities in the reconstruction process.
- Recommend concrete solutions to the problems identified during the study.

The report will serve as a basis for USAID's discussion of the issues surrounding municipal finance with the Government of Honduras (GOH), and USAID may also use the report to bring these issues to the attention of the international community during the next donor meeting in Stockholm, Sweden, in May 1999.

The study team's fieldwork took place between March 15 and March 31, 1999 in Honduras. The study team met with national level agencies of the GOH, international donors, and NGOs in the capital of Tegucigalpa and then visited five of the municipalities affected by Hurricane Mitch to prepare case studies. In addition, team members interviewed mayors from four small, remote Northeast Coast municipalities during their visit to Tegucigalpa.

The study team's main findings were:

National-Level Impact of Mitch

- The GOH estimates the national-level financial impact of Mitch at US\$5.0 billion.
- The GOH is not involving the municipalities in the preparation of the National Reconstruction Plan.
- The GOH announced that the municipal governments will be responsible for reconstruction of housing and infrastructure but has not included funding for them in its 1999 national budget. It appears that the GOH's plan is for most reconstruction projects to be implemented by national agencies such as the *Fondo Hondureño de Inversión Social* (the FHIS); the *Servicio Nacional de Obras Públicas, Transporte y Vivienda* (National Agency for Public Works, Roads, and Housing, SOPTRAVI); and the *Servicio Autónomo Nacional de Acueductos y Alcantarillados* (National Water and Sewer Agency, SANAA). These agencies do not allow for meaningful participation by local governments in the implementation of infrastructure projects and tend to undermine the process of decentralization.

- Relief of external national level debt is being negotiated, but there is no discussion of debt relief for municipalities.
- The central government is not meeting its commitment to transfer 5 percent of tax revenues to the municipalities as required by the 1990 law that provided the basis for decentralization.

Municipal-Level Impact of Mitch

- Approximately 100 of the 298 municipalities suffered damage from Hurricane Mitch. The extent of the damage varied greatly, with some communities completely devastated and others only mildly affected.
- Most of those that suffered moderate to severe damage spent their reserves for emergency relief and will not be able to take on the responsibility for the reconstruction unless they receive funds from the central government and international donors.
- Post-Mitch municipal revenue actually increased on a percentage basis in four of the five municipalities selected for case studies. This resulted from a combination of efforts, including privatization of some services; more efficient collection of some local taxes; and in some cases, increased revenue from sales taxes on items related to the reconstruction. The actual amounts collected are relatively small, and although they will cover short-term administrative expenses, they are not sufficient to make a significant contribution to long-term reconstruction.
- The small, poor, remote municipalities need immediate financial assistance for their short-term expenses as well as funding for longer-term reconstruction.
- Municipal budgets for 1999 do not include significant amounts for reconstruction projects because the municipalities do not have commitments of funds from the central government, and the law does not permit municipalities to include unfunded items in their budgets.
- Most municipalities have a list of priority projects, but none have yet completed reconstruction plans with firm cost estimates. Therefore, it was not possible for the study team to precisely determine the gap between local resources and what will be needed for reconstruction.
- Many municipalities have significant debt burdens that will inhibit their capability for reconstruction.

Summary of Issues and Recommendations

Following is an abbreviated version of the issues and recommendations of the study team. A more detailed description may be found in section 7 of this report.

1. Decentralization Policy

Issue: There are indications that central government support for decentralization is weakening and there is some fear that a large influx of funding for reconstruction through the central government could undermine the remarkable progress that Honduras has made toward decentralization during the past ten years.

Recommendations: (1) External donor funding for reconstruction projects should include conditions that support a continuing process of decentralization. (2) International donors should encourage the GOH to transfer the full amount (5 percent) of central government tax revenue to the municipalities as required by the 1990 Municipal Reform Law. (3) Donors should sponsor workshops and seminars to review the relative strengths and weaknesses of municipal governments vis-à-vis the central government and the interaction between the two levels of government.

2. Preparation of the National Reconstruction Plan

Issue: The central government has not involved the municipal governments, the Honduran Association of Municipalities (AMHON), or FUNDEMUN in the preparation of the National Reconstruction Plan.

Recommendation: Donors should encourage greater participation by the municipalities in planning and implementation of reconstruction projects and should consider channeling funds in a manner that ensures their participation.

3. Funding Channels and Implementation of Reconstruction Projects

Issue: There is a direct relationship between how funds are channeled and the role that municipalities can play in the implementation of reconstruction projects. The FHIS and other national agencies currently implement most infrastructure projects. The mayors contend that FHIS projects are extremely expensive, take much too long to complete, are not subject to local scrutiny, and undermine their role as providers of public services.

Recommendations: (1) Donors should review the policies and procedures of the FHIS to confirm that they support decentralization and do not have a negative impact on efforts to strengthen municipal governments. (2) Consideration should be given to creation of a new, complementary funding channel by establishment of a Municipal Development Loan and Grant Fund administered by FUNDEMUN-AMHON for small projects in the \$10,000 to \$50,000 range.

4. Grading System for Municipal Administrative Capacity

Issue: The FHIS grading system is apparently not being used as intended to grade the level of administrative capacity of the municipalities. The intention was that those receiving a higher grade should have more authority and independence to implement projects. Interviews with mayors of “A” rated municipalities indicate that they have little or no authority to act in projects funded by the FHIS.

Recommendation: FUNDEMUN should act as a certifying agency to confirm the appropriate grade for each municipality. At the same time FUNDEMUN should identify training and technical assistance needed to correct deficiencies and to help a municipality move up to a higher grade. The improved grading system would help funding organizations to determine the appropriate level of municipal participation in the implementation of reconstruction projects.

5. Municipal Financial Systems

Issue: The current system for budgeting, accounting, and reporting of municipal revenues and expenditures has a number of deficiencies and does not conform to international norms for government finance statistics. Financing from loans or the sale of bonds is classified as “revenue,” giving the impression of a balanced budget. The system does not reveal municipal deficits and gross borrowing requirements.

Recommendation: The sections of the 1990 law governing municipal finance should be revised to conform with international norms for government finance statistics, and municipal financial systems should be revised to meet international standards.

6. Municipal Debt

Issue: The GOH has made sound arguments explaining why its debts to international lenders should be forgiven as part of their support for reconstruction. The same arguments are valid for the debts that municipalities have to the Central American Bank for Economic Integration (CABEI), international organizations, and the *Banco Municipal Autónomo* (Municipal Development Bank, BANMA).

Recommendation: The GOH, AMHON, and FUNDEMUN should assist the municipalities in a review of their debts and arrange a “Debtors Conference” where municipalities can make a case for municipal debt forgiveness as part of the overall forgiveness of national debt.

THE ROLE OF MUNICIPALITIES IN THE RECONSTRUCTION OF HONDURAS: AN ASSESSMENT OF THE IMPACT OF HURRICANE MITCH

1 INTRODUCTION AND PURPOSE

USAID/Honduras is assisting the government and the people of Honduras with their efforts to recover from the effects of Hurricane Mitch, which struck the country during the last days of October 1998. The immediate relief phase has been completed, and the focus has now shifted to the recovery and reconstruction phases. In late February 1999, USAID/Honduras and the USAID/Washington Office of Environment and Urban Programs issued a Request for Services to ICMA and executed other contractual agreements with FUNDEMUN and AG International Consulting Corporation to form a four-person team to carry out this study. ICMA executed a sub-agreement with DevTech Systems Inc. for their participation. The team members were:

- Chuck Dean, ICMA Senior Municipal Advisor - Team Leader
- Mario Ivan Flores, FUNDEMUN Municipal Financial Specialist
- Mark Gallagher, DevTech Systems Chief Economist - Fiscal Advisor
- Phil Rourke, AG International President - Municipal Finance Consultant.

The work was carried out in close collaboration with Gail Lecce, USAID/Honduras Director for Municipal Development and Democratic Initiatives; Todd Sloan, USAID/Honduras Project Manager for Municipal Development; Mirtha Gonzales, Director of FUNDEMUN; and Romeo Ucles, Technical Director of AMHON.

1.1 Purposes

The purposes of the study were to:

- Describe the short- and long-term impact of Hurricane Mitch on the financial and administrative capacity of municipalities in Honduras.
- Identify specific issues and constraints that affect the capability of the municipalities to carry out their responsibilities in the reconstruction process.
- Recommend concrete solutions to the problems identified during the study.

This report is intended to focus attention on the challenges facing the municipalities in meeting the needs of their communities in the aftermath of Hurricane Mitch. The report will serve as a basis for USAID's discussion of the issues surrounding municipal finance with the Government of Honduras (GOH), and USAID may also use the report to bring these issues to the attention of the international community during the next donor meeting in Stockholm, Sweden, in May 1999.

1.2 Work Plan

The work plan for the study consisted of four steps:

- Review material describing the impact of Mitch on the municipalities from FUNDEMUN, AMHON, USAID, GOH central government agencies, and NGOs and interview representatives of these organizations.
- Conduct field visits to five municipalities to review the impact of Mitch with the mayors and department heads and visit damaged communities to consult with victims of Mitch.
- Prepare a draft report and review the main findings and recommendations with USAID/Honduras before departing Honduras.
- Complete the final report in Washington, DC.

AMHON provided preliminary damage estimates for each municipality, compiled in December 1998, and FUNDEMUN provided detailed pre-Mitch financial data on 22 municipalities. The fieldwork took place between March 15 and March 31, 1999, in Honduras. The study team met with GOH agencies, international donors, and NGOs in the capital of Tegucigalpa and then conducted case studies in five of the municipalities affected by Hurricane Mitch. In addition, the study team interviewed mayors from four small, remote Northeast Coast municipalities during their visit to Tegucigalpa.

1.3 Limitations of the Study

Some limitations of the study were the (1) short time frame of two and a half weeks, (2) unavailability of the GOH National Reconstruction Plan to indicate the level of financial and other support from the central government to the municipalities, (3) lack of municipal reconstruction plans and budgets, (4) small number of municipalities visited due to time constraints. To offset these limitations the team was able to access a great deal of information from USAID, AMHON, FUNDEMUN, the mayors of the five municipalities selected for visits, and the mayors of four small remote communities during their visit to Tegucigalpa (see Attachment A for a list of contacts).

1.4 Report Outline

Section 2 summarizes the process of decentralization in Honduras during the past decade and describes decentralization support provided to date by USAID. **Section 3** provides an overview of the pre-Mitch financial setting and a listing of the functions and responsibilities of the municipalities. This is followed by a review of municipal revenue resources. Section 3 also provides descriptions of the FHIS grading system to measure municipal administrative capacity, comments on deficiencies in the municipal finance system, an outline of how funds are channeled to the municipal level, and, finally, brief descriptions of municipal credit and debt.

Section 4 provides the results of the five case studies carried out by the study team in Catacamas, Choluteca, La Lima, El Progreso, and La Ceiba along with a summary of interviews with mayors from four smaller municipalities (Santa Fé, Santa Rosa de Aguan, Limón, and

Iriona). **Section 5** outlines the preliminary National Reconstruction Plan and comments on the status of reconstruction planning at the municipal level.

Section 6 includes the team's major findings from the case studies and interviews with AMHON, FUNDEMUN, mayors from small municipalities, central government officials, NGOs, USAID, and others. **Section 7** lists the most important issues and the team's recommendations to address them.

2 BACKGROUND: MUNICIPAL DEVELOPMENT, 1990–1999

USAID/Honduras has supported a wide range of activities to assist municipalities to improve their administrative and management capacity since the 1990 passage of the landmark *Ley de Municipalidades* (Municipal Reform Law, decree 134-90). The law was a remarkable change of course for Honduras after a long history of a highly-centralized form of government. Traditionally, mayors were appointed, or they won office as part of the same slate as the presidential candidate of their party. They served at the political whim of their party leaders, were easily and often replaced, and were not required to respond to the citizens of their communities. Municipalities had very little control over financial resources, and the right to tax was controlled by the central government. The 1990 law drastically changed the system, placing more power at the local level. It gave municipalities more autonomy based upon the following precepts:

- Unencumbered administration and independent decision making within the law.
- The authority to collect funds for the municipalities' exclusive use to benefit their citizens.
- Preparation, approval, execution, and administration of the municipal budget.
- Planning, organization, and administration of public services at the local level.
- Authority to create an independent administrative structure and work method.
- All other functions that fall under municipal jurisdiction in accord with the law.

The most important reforms that resulted from the 1990 law are:

- Assurance of regular funding from central government transfers of 5 percent of national tax revenue.
- Increased authority to raise local revenue through local taxes and fees.
- Improved organizational structure of local government.
- Increased citizen participation in local decision making through *cabildos abiertos* (open town meetings).

In 1991 USAID funded a municipal development project with technical assistance provided by ICMA to increase the administrative and management capacity of the 14 fastest-growing municipalities. The ICMA work was coordinated with AMHON and the central government during the first two years. In 1993, USAID and ICMA supported the establishment of FUNDEMUN to ensure that a permanent source of technical assistance and training would be available for the continuing task of improving municipal level management capacity.

Reforms in the electoral law allowed for separate votes for mayors for the first time in 1993, but candidates were still tied to the party of the presidential candidate. In 1997, the electoral reform law was fully implemented (after a major campaign from AMHON), and for the first time municipal authorities were elected by a separate ballot from the president and congress.

FUNDEMUN and AMHON have cooperated in providing a wide range of technical assistance and training for the municipalities. AMHON represents the municipalities' interest at the national level by making recommendations for improvements in national policy toward the municipalities and the legal framework for local government. In addition to support for technical assistance and training, USAID has provided funds for capital improvements (infrastructure) at the municipal level, thereby helping the municipalities to respond to the need of their citizens. USAID/Honduras support has focused upon efforts to increase citizen participation in local government, improve the delivery of public services, and strengthen the municipalities' administrative and financial capacity. An important part of this effort has been to help municipalities increase locally-generated revenues, implement financial controls, open the budget process to scrutiny by the citizens, and promote democratic participation in decision making by citizens in open town meetings. The progress has been extraordinary, and Honduras is considered a model for decentralization of government and democracy strengthening at the local level. However, there is now a perception among many of the mayors and others involved in municipal development that progress toward decentralization and a more democratic local government is not moving ahead. They cite the decline in the transfer of central funds from 5.2 percent in 1992 to approximately 1.0 percent in 1998; implementation of local level infrastructure projects by central government agencies (instead of the municipalities); and, more recently, the preparation of the National Reconstruction Plan without the participation of the municipalities.

Just before Hurricane Mitch hit Honduras in October 1998, AMHON had planned a major campaign to encourage public support for central government compliance with the legal requirement to transfer the entire 5 percent of revenues. AMHON has now rescheduled an "Extraordinary National Assembly" of the 298 municipalities that will be held in Tegucigalpa in late April 1999. The purpose of the assembly will be to focus attention on the lack of resources at the local level at the same time municipalities are facing growing demands from citizens to respond to the problems created by Mitch.

Citizens view the devastation from Hurricane Mitch as a local problem and are looking to the municipalities for assistance. The central government has announced that responsibility for reconstruction of the "social sector" (housing, health facilities, and schools) and infrastructure is the responsibility of the municipalities. However, there is no announced plan to transfer the resources the municipalities need to meet these responsibilities. Immediately following Mitch, many municipalities were isolated from the central government and used their meager resources for the emergency, attending to displaced persons and buying food, medicines, and emergency supplies. As a result, they used all of their reserves; many have not had enough funds to meet their payroll, and some have made drastic reductions in staff at a time when their workload has dramatically increased.

USAID/Honduras and the USAID Office of Foreign Disaster Assistance (OFDA) provided assistance to the municipalities in four areas immediately following Mitch: (1) reimbursement, through AMHON, of emergency expenses to 20 of the municipalities that suffered the most from Mitch; (2) repair of emergency water systems through the FHIS; (3) clearing of debris, cleanup and road building, also through AMHON; (4) construction of transitional shelters in eight municipalities for displaced persons while permanent housing is being built; and (5) assistance to NGOs and municipalities for the construction of permanent housing for victims of Mitch. In addition to the assistance from USAID, many municipalities have received assistance from other donors and from NGOs for reconstruction activities.

In summary, Hurricane Mitch has caused a severe strain on the financial and administrative capacity of the municipalities. Some of the larger municipalities are coping with the situation reasonably well. Other smaller, more remote municipalities are in desperate need of help, especially those in the coastal areas of Colón Department. The municipal governments believe they can do much more to meet the needs of their citizens if they receive funding and authority to implement projects at the local level.

3 PRE-MITCH PUBLIC FINANCE SETTING AND INTERGOVERNMENTAL FISCAL RELATIONS

3.1 Overview

In the first few years of the 1990s, the government of President Rafael Callejas followed expansionary macroeconomic policies to spur economic growth, but at the cost of destabilizing the domestic economy and the country's international accounts. Fiscal deficits grew from less than 1 percent of Gross Domestic Product (GDP) in 1991 to a peak of almost 10 percent in 1993. Foreign reserves started to decline, and interest rates rose to very high levels. After the expansionary impetus of 1992 and 1993, inflation accelerated, rising from only about 7 percent to 13 percent in 1993 and then to levels surpassing 25 percent from 1994 through 1996.

After 1993, the GOH initiated a rather successful fiscal and monetary adjustment program in an attempt to build a more solid basis for future economic growth and stability. Fiscal deficits declined on a steady basis from 1993, at the high of 9.8 percent of GDP, to 1998's preliminary deficit of only 1.0 percent. This fiscal adjustment was achieved mainly by increasing nontax current revenues of the fiscal sector, while holding current spending at constant levels (as a percentage of GDP) and reducing capital spending from a high of 14.8 percent of GDP in 1993 to only 10.0 percent in 1998. This program was successful in that inflation has declined to pre-1993 levels and is projected to reach about 15 percent in 1999, and interest rates have dropped markedly, hence setting the basis for private sector-led economic growth. GDP growth has accelerated, rising from -1.3 percent in 1994 to an estimated 5.0 percent in 1998.

Economic performance started to improve in 1997 and continued to strengthen during the first nine months of 1998. Real GDP growth accelerated to 5 percent in 1997 and to approximately 5.2 percent in the 12-month period to the end of September 1998. Fiscal performance also improved during January-September 1998. The central government deficit narrowed to about 2

percent of GDP from 3 percent in 1997. This situation has changed dramatically now that the GOH is faced with reconstruction after Mitch.

3.2 Municipal Responsibilities and Functions

Municipal governments have a clear role and set of functions according to the revised National Constitution revisions of 1982, which state that they are independent of the central government and are endowed with autonomy in a variety of areas. It should be noted that municipalities are not empowered to create taxes; this power resides solely with the National Assembly. The responsibilities of municipalities are more precisely specified in Article 13 of the 1990 Municipal Reform Law, which specifies that municipalities are responsible for the following areas:

- City planning and land use
- Parks and gardens, trash collection, and sanitary conditions
- Water and sewage systems, maintenance, and administration
- Construction and maintenance of public roads, in conjunction with other entities
- Construction and maintenance of cemeteries, markets, and slaughterhouses
- Coordination with state entities in the management and use of natural resources— environmental protection and reforestation
- Maintenance, cleaning, and general control of streets, parks, beaches, and other municipal areas
- Encouragement and regulation of trade, industry, and service businesses
- Control and regulation of public entertainment, including shows, bars, restaurants, night clubs, etc.
- Promotion of tourism, culture, sports, and education
- Establishment and maintenance of the fire department
- General provision of public services, sometimes in coordination with other institutions of the state
- Partial participation in the contracting process for public works
- Certain health measures
- Management, construction, and maintenance of electrification of the municipality, along with the National Energy Company (ENEE)
- Coordination of local with national development plans.

3.3 Sources of Municipal Revenue

Following is a description of the main sources of municipal revenue.

3.3.1 General Municipal Transfers

In order to carry out the functions listed above, the 1990 law provided for transfers from the central government to the municipalities of 5 percent of the central government tax revenues to supplement local revenues. According to the Municipal Reform Law of 1990, the transfer program was to be implemented gradually. Per article 124 the transfer was to reach only 2 percent of tax revenues in 1992, 4 percent in 1993, and then 5 percent from 1994 onward.

The requirements as specified in article 124 were exceeded in 1992 and 1993 but have not been attained since then. In 1992 the general municipal fiscal transfers actually amounted to 5.2 percent of central government tax revenues. In 1993 they declined to 4.2 percent and to 3.7 percent in 1994. Transfers have continued to decline to 1.0 percent in 1998.

The trend in the share of central government tax revenues that was transferred to municipalities is shown in figure 3.1 and table 3.1. Figure 3.1 shows a slight increase in the projected transfers to tax revenue ratio for 1999. This projection does not reflect rising amounts of transfers but rather a decline in tax revenues.

Figure 3.1: Central Government Transfers to Municipalities as Percentage of Total Tax Revenues

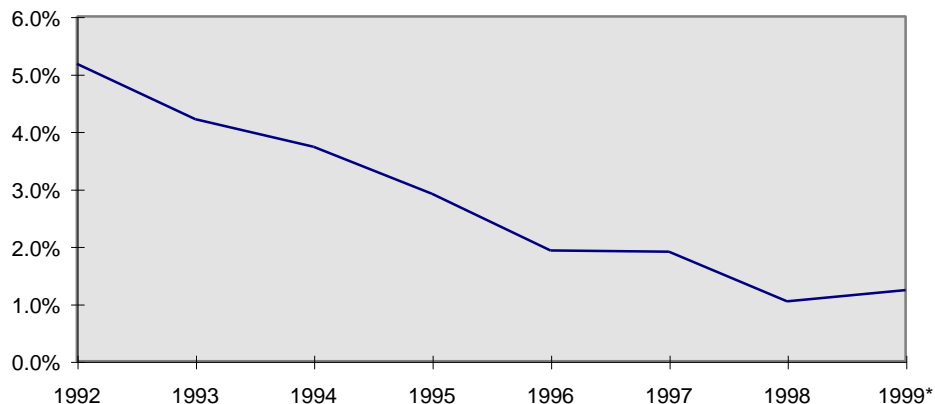


Table 3.1: Central Government Transfers to Municipalities

Type of Transfer	1992	1993	1994	1995	1996	1997	1998	1999*
Capital	140.3	141.2	152.4	131.4	124.5	152.3	135	135
Current	34.4	7.6	7.6	49.5	10.3	12.5	15	15
Total Transfers	174.4	148.8	160	180.9	134.8	164.8	150	150
Tax Revenue	3,375.9	3,534.6	4,286.3	6,206.5	7,002.1	8,651	14,376	12,137
Transfers as % of tax	5.20%	4.20%	3.70%	2.90%	1.90%	1.90%	1.00%	1.20%

*Preliminary plan for calendar year 1999.

Source: Data from Ministry of Finance and Public Credit.

3.3.2 Revenue from “Port Charge” Sharing

Some municipalities do not receive the general municipal transfers discussed above. Instead, they receive a share of “port charges.” Article 91 of the Municipal Reform Law of 1990 explicitly excludes from the general municipal transfer those municipalities that benefit from an earlier decree (No. 72-86) from 1986, which specifies that 4 percent of the port fees and 4 percent of customs fees collected would be shared with seven municipalities: La Ceiba, Puerto Cortes, Tela, Trujillo, Roatan, San Lorenzo, and Amapala.

3.3.3 Locally-Generated Revenues

Municipalities are authorized to collect a wide range of taxes and fees from local sources. These taxes are uniform for the entire country and are established by the 1990 Municipal Reform Law. Municipalities are not empowered to establish their own taxes, and for the most part they are not empowered even to set the rates for the taxes they impose. They do have some authority to set fee rates or levels, since these are linked to the cost of providing services. Following are lists of the taxes and fees that municipalities are authorized to collect. These taxes and fees are referred to as either current or ordinary revenues of municipalities. This list is based on the Municipal Reform Law and related regulations.

3.3.3.1 Taxes

- Fixed property tax
- Personal income tax
- Business tax
- Pool halls and price-controlled products tax
- Natural resource exploitation tax
- Property transfer tax
- Cattle tax.

3.3.3.2 Fees and Service Charges

Municipalities are authorized to establish and collect fees and service charges for (1) specific services, both directly and indirectly provided; (2) use of municipal facilities, such as communal buildings or parking spaces, and (3) other administrative services that municipal authorities provide. Fees and service charges (called *tasas*) are established on an annual basis and are included in the municipality’s annual fiscal program (*plan de arbitrios*). Per law, the fees charged are to be based on the cost of providing the service.

3.3.3.3 Valorization or Betterment Levy

Municipalities are authorized to impose additional charges, usually against fixed properties, to recuperate all or part of the cost of specific public works projects that are determined to specifically benefit a subgroup or area of the municipality.

3.4 Municipal Credit

Municipalities are authorized to arrange for loans from any domestic institution, although they are encouraged to seek loans mainly from state sources. To the extent they would receive loans from foreign institutions, these must be undertaken in accordance with the national Public Credit Law of 1990.

Municipalities are also authorized to issue bonds for the financing of specific works or projects. These bonds can be sold in the country's bond market. Before the municipality may issue bonds it must have approval from both the Ministry of Finance and Public Credit and the Central Bank. Other restrictions also apply and can be found in the regulations.

When municipalities sell land or buildings or certain equipment, the revenues generated from the sale are considered capital revenue. Loans and bond sales are also considered capital revenue.

Transfers from the central government may be considered capital revenue, even though the central government determines that 90 percent of its regular transfer to municipalities is capital transfer, and 10 percent is current transfer. The issue of transfers is discussed in more detail in section 3.3.1 above.

When municipalities are authorized to borrow or to float bonds, the proceeds must only be used to fund investment spending. In addition, municipalities can fund investment spending from current revenues. Box 3.1 lists the sources of credit and funding for municipal infrastructure investment. Amounts are not available.

3.5 Deficiencies in Municipal Financial Systems

Most municipalities have greatly increased their financial management capacity in recent years, many with assistance from AMHON and FUNDEMUN and backup support from USAID. Their budgets are open to public scrutiny, and their financial control and accounting meet local standards. However, their current municipal financial systems are based upon tradition and the 1990 law and include concepts that are not consistent with international standards established in the 1986 *Manual for Government Finance Statistics* published by the International Monetary Fund (IMF). Financing from loans or the sale of bonds is classified as "revenue," giving the impression of a balanced budget. As a result, the system does not reveal municipal deficits and gross borrowing requirements. The sections of the 1990 law governing municipal finance should be revised to conform to international norms for government finance statistics, and municipal financial systems should be revised to meet international standards.

Box 3.1: Sources of Funding for Municipal Infrastructure Spending

- Municipal current revenues.
- Municipal capital income (such as sales of property or the receipts from privatization).
- Central government transfers: 90 percent of the general municipal transfer is specified for capital investment use.
- The FHIS (see earlier discussions on the FHIS).
- USAID/FHIS: Assistance funds channeled through the FHIS.
- BANMA: Loans are still outstanding, but this source is not available for future loans. Interest payments to BANMA have been suspended.
- Direct loans from the Inter-American Development Bank (IDB). Only Puerto Cortés has had access to direct IDB loans.
- Commercial banks: Many municipalities use this source. These loans are at commercial rates.
- Municipal bonds: Only San Pedro Sula has issued bonds.
- Leasing.
- PROMUNI: This is a Central America regional project implemented by the Central American Bank for Economic Integration (CABEI) and funded by USAID, IDB, and the World Bank. Honduran municipalities have not yet accessed this funding source. The fund is awaiting replenishment.

Source: Phelps and Kehew, 1998.

3.6 Transparency and Flow of Funds for Municipal Development

There is a direct relationship between how funds for municipal development are channeled and the degree of responsiveness that municipalities have in meeting the needs of their citizens. Funds raised at the local level and then spent by the municipalities for administration or for capital projects are within the control of the municipalities. They have the authority to use these funds for the public good and the responsibility to account for their use to the public. The 1990 Municipal Reform Law provides for a more open budget process with public access to the municipal budget breakdown and also requires town meetings five times each year where citizens question local officials on the use of locally-generated public funds. During the past few years there has been great progress in making the budget process in Honduras more open and “transparent” as a direct result of the USAID support for municipal development through FUNDEMUN and AMHON. In some municipalities, budgets now include items presented by citizen groups at the town meetings, and local officials are required to report back to the citizens on the progress of implementation of projects and costs. This is a remarkable accomplishment in a country and a region that, historically, has not had democratic citizen participation in the decision-making process or such public scrutiny of the use of public funds.

The following describes how funds from external sources have been channeled in recent years.

3.6.1 Funds from the Central Government

Funds received by the municipalities from the central government can be divided into those used for administration and those used for capital projects. Funds are transferred directly to the municipalities on a quarterly basis as part of the municipal financial transfers described in section 3.3.1. The municipalities use and account for these funds according to the law. (Up to 10 percent may be used for administration, and at least 90 percent must be used for capital investment infrastructure.) Central government funds for infrastructure and other capital projects are mainly channeled through the FHIS, SANAA, and SOPTRAVI. The municipalities play a minor role in the planning and implementation of these projects. This practice works against a continuing process of decentralization and increasing citizen participation (and public scrutiny) of the use of public funds, and it constrains the development of more efficient, more responsive local government.

3.6.2 USAID Funds

USAID has used various channels for its municipal development funds during the past ten years: some were channeled directly to municipalities, and some USAID funding flowed through BANMA. Since the demise of BANMA a few years ago, USAID support for municipal infrastructure has mainly been through the FHIS. However, in February 1999, USAID made a grant to AMHON, which was passed to municipalities severely affected by Mitch for restoring water supplies, clearing streets, and repairing roads. The municipalities have very much appreciated this assistance through AMHON because it is allowing them to rapidly respond to the needs of their communities in a manner that increases their credibility with local citizens. USAID/Honduras is also assisting the municipality of Tegucigalpa and seven others to provide emergency shelter and permanent housing and related infrastructure by combining the resources of NGOs with those of municipal administrations. This is proving to be a quick, efficient way to assist the victims of Mitch while continuing support for municipal development at the local level.

3.6.3 Funds from Other Donors

There have been a number of recent public announcements of financial support for reconstruction projects in many of the municipalities affected by Mitch. The governments of Germany, Japan, Taiwan, Spain, Sweden, and others have announced their support for housing reconstruction and other infrastructure projects in Tegucigalpa and other municipalities. Some of these funds will apparently flow through the central government, and other funds will flow through NGOs. The IDB had been providing loan funds to the municipality of San Pedro Sula for several years prior to Mitch. These IDB loans were made through the central government, but disbursements flow directly to the municipality of San Pedro Sula, and the municipality has the major responsibility for implementation. The IDB loans to San Pedro Sula have been tied to municipal reforms and accompanied by IDB-funded technical assistance to improve the efficiency of the municipal administration. The most recent loan requires the municipality to make a significant reduction in its staff (600 positions) as a condition of the loan.

3.7 Municipal Financial and Administrative Capacity and FHIS Grading System

The two largest Honduran municipalities, Tegucigalpa and San Pedro Sula, have populations of approximately 800,000 and 500,000, respectively. The third largest is Danli with a population of about 120,000, followed by La Ceiba with a population of approximately 110,000. The populations in the remaining municipalities range downward from 90,000 in Juticalpa to about 14,000 in Roatan. In general, the larger, richer municipalities have greater administrative capacity, and the smaller, poorer ones have less.

The FHIS has established a grading system with four categories (A, B, C, and D) to grade the municipalities' level of administrative capacity to carry out infrastructure projects. The criteria for placement in one of the categories are (1) level of revenue, (2) administrative capacity, (3) community participation (town meetings) and social promotion, (4) index of nutrition and literacy, (5) financial capacity, and (6) size of population. Those municipalities with the highest score are placed in category "A," and they are expected to assume a greater level of responsibility and autonomy in implementation of capital projects. Those in the lower categories have less authority and responsibility for implementation of projects funded through the FHIS. The study team discussed this system with several mayors and others involved in implementation of municipal projects through the FHIS. The general opinion was that the system does not function as intended, and in fact the municipalities (even those in category "A") play a minimal role in implementation of FHIS projects. Several mayors expressed the opinion that the FHIS projects are much more expensive and take much more time than would be the case if the municipalities could take a major role in implementation. They also point out that the municipalities' activities are subject to review and scrutiny by local citizens and local press, and therefore their project implementation activities are much more "transparent" than those of the FHIS or other agencies of the central government such as SOPTRAVI, SANAA, or ENEE.

Some municipalities (e.g., Puerto Cortez, San Pedro Sula, and Choluteca) have demonstrated a high level of administrative capacity for the planning and implementation of capital projects. In recognition of this higher capacity, USAID and IDB have made funds available to selected municipalities for project implementation. However, most USAID and IDB funding for local level capital projects has been channeled through the FHIS.

4 CASE STUDIES OF HONDURAN MUNICIPALITIES

This section describes the impact of Mitch on five municipalities that were selected by the team in consultation with USAID, FUNDEMUN, and AMHON. The team visited each of these municipalities, held conversations with the mayors and staff, reviewed financial and other data, and visited areas damaged by Mitch. These five municipalities all receive technical support from FUNDEMUN and are among the better-managed municipalities in the country.

Catacamas is located in the eastern department of Olancho, a predominantly agricultural, ranching, and timber-producing region of the country. Choluteca is located in the South of Honduras on the Pacific Ocean, an area where shrimp farming has assumed major economic importance in the last 15 years. El Progreso, La Ceiba and La Lima are all situated in the fertile

North Coast plain fronting on the Caribbean Sea and long associated with banana production for export.

4.1 Catacamas

4.1.1 Setting

Catacamas is the largest municipality in the department of Olancho, with an area of 7,261 square kilometers. It has a total population of 80,000, of which 35 percent is considered urban. The municipality of Catacamas is located 208 kilometers east-northeast of Tegucigalpa.

4.1.2 Hurricane Damage and Emergency Assistance

While loss of life was relatively low in Catacamas, Hurricane Mitch destroyed 352 homes, about a dozen school buildings, numerous large bridges, several kilometers of roads, the city's main potable water intake, and approximately 1.5 kilometers of 14-inch water mains. Large numbers of cattle drowned, and significant areas planted in coffee were lost to landslides.

Presumably because of the relatively low loss of life in Catacamas, the Municipal Emergency Committee (CODEM) rated Catacamas as "Priority 7." As a consequence, municipal officials report that they have received minimal assistance from the central government since the disaster. In their view, aid from the GOH, foreign donors, and NGOs has been concentrated almost exclusively on Tegucigalpa, Choluteca, and the main municipalities of the North Coast, despite the fact that municipalities such as Catacamas also suffered extensive damage and continue to be at great risk from the coming rainy season. In particular, municipal officials fear physical isolation and major economic losses if three key bridges are not repaired in time; severe health problems if timely repairs are not made to the potable water system; and the continuing spread of malaria and dengue, both of which have increased significantly since the hurricane.

Temporary repairs of the potable water system were accomplished by the municipality itself, using pipe donated by USAID through SANAA. However, intake facilities have not been repaired (settling and pretreatment tanks), and the pipe has been laid directly in the river bed, with no permanent concrete anchors. Water quality is deficient now, and the pipes will be lost unless permanent supports can be built before the rapidly approaching rainy season, potentially leaving the city of Catacamas without any piped water supply at all. Responsibility for repairing the water system currently lies with SANAA, but there has been no action from this agency to date. Municipal officials suspect that SANAA may be reluctant to make further investments in the Catacamas water supply system at least in part because the system has been slated for devolution to the municipality. Lack of clear delineation of current responsibilities between the municipality and the national water utility, coupled with uncertainty as to the pace, extent and financial basis of decentralization, have combined to produce inaction on this critical matter.

A similar situation exists with regard to the replacement of three major road bridges that are critical to maintaining timber and coffee operations, both of which are mainstays of the local economy, during the upcoming rainy season. In the case of timber, the impact on municipal finances is direct. The municipality owns large tracts of forest lands and normally expects to earn

about L 4 million annually from the sale of standing timber. This represents almost 45 percent of current revenues that were forecast for 1999 before the hurricane. The three bridges, one of which has a span of 96 meters, are estimated to cost L 48 million to replace. Responsibility for rebuilding them lies with SOPTRAVI, but, again, there is little likelihood that they will be rebuilt in time for the rainy season, and the community anticipates having to sustain further substantial economic and financial losses as a result.

The FHIS has provided some assistance in making smaller emergency repairs to rural roads, schools, and health centers. Municipal officials complain, however, of the low quality and high cost of works executed by the FHIS, and believe that the FHIS should either limit itself to simply providing funding for projects identified and implemented by the municipality itself, or, at a minimum, require that the municipality approve the selection and payment of contractors based on direct supervision of construction by municipal representatives. Another deficiency that was mentioned in regard to FHIS' school and health programs is that these programs make no provision to finance recurrent expenditures such as medical supplies and teachers' salaries.

4.1.3 Short-Term Revenue and Expenditure Impacts

Like most other municipalities in Honduras, tax and service revenues fell sharply immediately following the hurricane. Catacamas closed 1998 having only collected 57 percent of total revenues that had been budgeted for the year, although about 85 percent of the revenue shortfall was due to lost timber sales and the postponement or cancellation of external assistance programs that had been planned during the early part of the year. As shown in table 4.1, not counting these important nontax revenue items, Catacamas was able to collect almost 90 percent of budgeted tax and service revenues during 1998.

Table 4.1: Catacamas Revenue Analysis, Fiscal Year 1998

Revenue Item	Budget	Shortfall	% of Total Shortfall	% Collected
Property taxes	479,527	111,748	1.9%	76.7%
Personal taxes	82,320	(9,238)	-0.2%	111.2%
Sales taxes	1,078,343	200,493	3.4%	81.4%
Other taxes	278,500	(65,622)	-1.1%	123.6%
Sewer & garbage collection	1,059,245	605,945	10.2%	42.8%
Leases	466,630	(36,526)	-0.6%	107.8%
Licenses & fees	896,811	108,015	1.8%	88.0%
Sale of Standing Timber *	4,219,869	3,225,530	54.1%	23.6%
Other Current Revenue	388,117	(13,021)	-0.2%	103.4%
Sale of Municipal Property	406,000	(273,293)	-4.6%	167.3%
5 % Transfer from GOH	1,700,000	(111,129)	-1.9%	106.5%
Transfers from FHIS *	280,000	239,000	4.0%	14.6%
International donations *	1,184,106	1,184,106	19.9%	0.0%
Loan disbursements *	434,000	434,000	7.3%	0.0%
Betterment tax revenues	857,927	362,589	6.1%	57.7%
Total Budgeted Revenues	13,811,395	5,962,597	100.0%	56.8%
Excluding items with an asterisk	7,693,420	879,961	14.8%	88.6%

The municipality has only received about L 59,000 through the USAID/FUNDEMUN emergency expenditure reimbursement program, but it has not incurred any extraordinary debt to this point. Emergency expenditures of about L 385,000 have been largely financed through the cancellation or postponement of a portion of the municipal investment program for 1999, which includes such items as street paving, extension of sewers and storm drains, and the construction of oxidation ponds for sewage treatment.

4.1.4 Current Situation and Prospects

4.1.4.1 Revenue Analysis

As indicated in table 4.2, revenue performance in Catacamas continues to lag behind budget through the end of February 1999, although some of the shortfall may be due to seasonal changes in the collection of some major taxes, such as property taxes. Nevertheless, on a prorated basis, it would appear that total revenue collections were only 65 percent of budgeted amounts through end-February, with blocked timber sales again contributing heavily to the estimated shortfall. Transfers from the central government also appear to be significantly behind schedule. On the other hand, collections of the municipal sales tax (*Impuesto sobre Industria, Comercio y Servicios*)—another important revenue source for Catacamas—appear to be considerably ahead of budget, consistent with municipal officials' reports of an intensified revenue collection effort for this tax.

Table 4.2: Catacamas Revenue Analysis, January 1–February 27, 1999

Revenue Item	Budget - 1999	% Contribution	Prorated 1/1-2/27	Collected 1/1-2/27	Collection %
Property Tax	662,714	4.2%	105,305	77,538	73.6%
Personal Income Tax	110,700	0.7%	17,590	56,401	320.6%
Natural Resource Extraction Tax	65,967	0.4%	10,482	8,809	84.0%
Sales Tax	1,188,123	7.5%	188,793	368,523	195.2%
Slaughter Permits	370,000	2.3%	58,793	69,549	118.3%
Sewer Service Charges	618,371	3.9%	98,259	62,322	63.4%
Garbage Collection Charges	440,874	2.8%	70,055	43,740	62.4%
Lease of Mun. Markets	900,000	5.7%	143,010	119,909	83.8%
Lease of Mun. Slaughterhouse	100,000	0.6%	15,890	28,239	177.7%
Other Lease Income	66,240	0.4%	10,526	-	0.0%
Licenses & Fees	962,008	6.1%	152,863	310,711	203.3%
Sale of Standing Timber	4,000,000	25.2%	635,600	-	0.0%
Other Current Income	327,000	2.1%	51,960	93,344	179.6%
Sale of Municipal Property	2,006,000	12.6%	318,753	174,973	54.9%
Transfer 5% GOH Tax Revenues	2,200,000	13.9%	349,580	148,108	42.4%
Transfers from FHIS	100,000	0.6%	15,890	-	0.0%
Fondo del Café	46,078	0.3%	7,322	-	0.0%
International Donations	200,000	1.3%	31,780	-	0.0%
Betterment Tax Revenues	1,500,000	9.5%	238,350	76,265	32.0%
Total Budgeted Revenues	15,864,075	100.0%	2,520,802	1,638,431	65.0%

Despite the impacts of Hurricane Mitch, Catacamas has not incurred any additional indebtedness during 1998 or so far in 1999. Short-term liabilities as of end January 1999 were only L 305,000, as against current assets of about L 3.3 million. The municipality only has L 2.6 million in long-term debt (of which approximately L 2.4 million is owed to USAID), as against total assets of just over L 26 million. Despite the continuing revenue impacts of Mitch, one can conclude that municipal finances are essentially sound.

4.1.4.2 Assessment of Administrative Capabilities

The team met with a group of about ten key municipal officials during its visit and believes that the municipality has a relatively high capacity to undertake significantly greater project implementation responsibilities. This assessment is based, in part, on the team's perceptions of the skills and training of the technical and administrative personnel interviewed, in part on the reports of FUNDEMUN, and in part on the basis of reported prior experience, which includes the management of up to L 7 million in annual investment in recent years. The overall municipal budget reportedly has grown from about L 2.5 million to L 12 million, only in the last five years. Training and technical assistance provided by FUNDEMUN was reported to be a key factor in enabling the municipal government to successfully grow at this pace.

4.1.5 Expenses for Reconstruction

With assistance from FUNDEMUN, Catacamas is preparing a post-Mitch reconstruction plan that should be available shortly (in less than 30 days). This plan will provide the basis for updating the 1999 municipal budget. The municipality hopes that more information will also be available on outside funding options within this time frame, including GOH and donor-funded programs that have yet to be clearly defined.

Preliminary estimates of investments required to restore key items of municipal infrastructure in Catacamas are summarized in table 4.3 below.

**Table 4.3: Catacamas Reconstruction Cost Estimates
(in Lempiras)**

Sector/Project:	Estimated Investment Cost	Short-Term Priorities and Responsibilities	
		Municipality	GOH
Healthcare Facilities	2,439,450	2,025,950	
Schools (consultant's estimate)	5,000,000		5,000,000
Emergency Housing	14,900,000	14,900,000	
Potable Water System	12,550,000		12,550,000
Sewage System, incl. Latrines	2,610,000	2,610,000	
Storm Drains	1,800,000	1,800,000	
Street Paving & Repair	5,680,000	5,680,000	
Flood Controls	3,550,000		3,550,000
Bridges			
Paso del Burro	20,000,000		20,000,000
Rio Talgua	8,000,000		8,000,000
Vallecito de Rio Tinto	3,000,000		
Talgua Arriba	700,000		

Jamarisque Abajo	700,000		
Puente en Poncaya	20,000,000	SOPTRAVI	20,000,000
Disaster Preparedness (Equip. & Supplies)	8,550,000	NA	
Total	109,479,450	27,015,950	69,100,000
Included in FY1999 Budget (pre-Mitch)		4,000,000	
Estimated Current Funding Gap (3/31/99)		23,015,950	NA
(including disaster preparedness)		31,565,950	

As shown, total estimated reconstruction costs are about L 110 million, equivalent to about US\$8 million. Of this, about half is required to rebuild major highway and road bridges that are located within the municipality and that are vital to maintaining economic activity and municipal revenues during the coming year.

The municipality and FUNDEMUN have identified immediate priority investments that it plans to undertake, including healthcare facilities, emergency housing, sewage system repairs, drainage, and street repairs that add up to approximately L 27 million. In addition, Catacamas has identified approximately L 69 million in urgent investments that presumably will be made by the appropriate central government agencies.

Only about L 4 million of the 27 million in priority municipal investments for reconstruction had already been included in the pre-Mitch 1999 budget. A reformulated budget for 1999 that would allow Catacamas to implement priority reconstruction programs will therefore need to find the means to close an estimated funding gap of L 23 million (US\$1.6 million). This gap grows to approximately L 32 million (US\$2.3 million) if, as would appear to be prudent in light of weather forecasts for 1999, Catacamas makes provisions to better mitigate any future flooding and landslide disasters that may occur in this region.

4.2 Choluteca

4.2.1 Setting

Choluteca is located in the southernmost department of Honduras near the Gulf of Fonseca. Its population is approximately 90,000. The main industries and sources of employment are agriculture (melons, cattle, sugar cane), port service, and fishing.

4.2.2 Hurricane Damage and Emergency Assistance

Choluteca was one of the most severely damaged municipalities because of flooding of the Choluteca river, which destroyed the homes and businesses of several thousand people.

4.2.3 Short-Term Revenue and Expenditure Impacts

The impact of Mitch on the finances of the municipality of Choluteca will likely be felt over the immediate and long term. The revenue base has not been severely damaged, but the costs of relocating victimized families and making infrastructure repairs will be felt into the future. Regular municipal revenues are unlikely to decline, but the need for immediate spending, in part financed by borrowings, will have longer-term implications.

Some of the team's findings were unexpected. For instance, while regular municipal revenues were down by 50 percent in November 1998 (immediately following the hurricane), compared to the same month in the prior year, for each of the following months regular revenues were rather robust. For 1999 the municipal government expects total revenues to rise by about one-fourth compared to 1998, and regular revenues are expected to rise about 10 percent, in keeping with general price inflation. This expected 10 percent increase is much lower than the nearly 30 percent increase experienced last year, despite Mitch and "los Niños," but clearly the municipal revenues are not expected to plummet.

There are three reasons why the regular revenue prospects are somewhat positive. First, the tax base has not been severely affected. Most of the property damage that has occurred in the municipality has affected the poorest of the poor, who were not contributing much to the tax base even prior to the hurricane. Indeed, 86 percent of the families whose homes were damaged or destroyed were from the lowest income category. While a hotel has been destroyed and other businesses have also suffered damage, most of the economic destruction was of sectors that are not subject to taxation because they generate "nontraditional exports" such as shrimp farming. While there are indirect income effects caused by this loss of economic base, the impact is much lower than it would have been had these industries been directly contributing to municipal revenues.

Second, cadastre values were last set in 1995, but it was agreed with the community that the 1995 taxable values would only be implemented over a period of four years (1995–1999). This means that the taxable value of property in 1999 would be equal to the cadastral value from 1995, for the first time. This implies an increase in taxable values of 25 percent compared to 1998. The municipal authorities are expecting property tax revenues to be the same in 1999 as they were in 1998. If there had been no Mitch, Choluteca could have expected property tax revenues to increase by 25 percent (L 1.0 million).

Third, the sales of wood, block, and other building materials, plus the added economic activity due to post-Mitch reconstruction has caused the tax collection from "commerce, industry, and services" to rise. Indeed, the municipal authorities expect this tax source to increase by about 35 percent. Considering that this is the single greatest tax source, the increase is substantial.

Foreign assistance, in grants, has helped the municipality with some of the reconstruction. In November 1998 foreign assistance received was L 355,311 and in December it was L 204,000. Choluteca received no foreign assistance in the same months in the prior year.

4.2.3.1 Choluteca Revenue Analysis

Table 4.4: Choluteca Revenue Analysis, January 1–February 28, 1999

Revenue Item	Budget – 1999	% Contribution	Prorated 1/1-2/28	Collected 1/1-2/28	Collection %
Property Tax	4,000,000	15.0%	646,400		0.0%
Personal Income Tax	400,000	1.5%	64,640		0.0%
Natural Resource Extraction Tax	50,000	0.2%	8,080		0.0%
Sales Tax	4,887,967	18.4%	789,895		0.0%
Slaughter Permits	550,000	2.1%	88,880		0.0%
Sewer & Garbage Service Charges	400,000	1.5%	64,640		0.0%
Lease Income	2,917,690	11.0%	471,499		0.0%
Licenses & Fees	3,207,300	12.0%	518,300		0.0%
Sale of Goods	120,100	0.5%	19,408		0.0%
Other Current Income	1,280,792	4.8%	206,976		0.0%
Collection of Overdue Taxes	1,700,500	6.4%	274,801		0.0%
Collection of Overdue Charges	130,000	0.5%	21,008		0.0%
Subtotal, Current Revenues	19,644,349	73.8%	3,174,527	4,732,171	149.1%
Sale of Municipal Property	821,995	3.1%	132,834		0.0%
Transfers from the Public Sector	4,288,285	16.1%	692,987		0.0%
Transfers from the Private Sector	756,625	2.8%	122,271		0.0%
Domestic Loans	100,000	0.4%	16,160		0.0%
International Loans & Donations	-	0.0%	-		0.0%
Betterment Tax Revenues	574,604	2.2%	92,856		0.0%
Cash Balances	450,000	1.7%	72,720		0.0%
Subtotal, Capital Revenues	6,991,509	26.2%	1,129,828	1,022,051	90.5%
Total Budgeted Revenues	26,635,858	100.0%	4,304,355	5,744,222	109.9%

4.2.3.2 Expenses for Reconstruction

The costs to the municipality for Mitch include the purchase of land, which will be sold in lots to the beneficiaries; the costs of building houses, which are mainly covered by foreign donors; infrastructure repair; and food assistance. These expenditures have mainly been made in the last two months of 1998, while land purchases do not appear in the fiscal accounts. The World Food Program and other donors are providing much of the food assistance, although the municipality did provide immediate emergency relief. It is still difficult to separate out the revenue increases due to the reconstruction spending; however, it is significant that in January 1999 current spending was 36 percent greater than in January 1998, and for February the figure amounts to 47 percent over last year. The comparative structure of Choluteca's municipal spending is illustrated in figures 4.1 and 4.2. The first compares spending in January and February of this year with that of 1998. The second chart compares budgeted expenditures for 1999 to estimated expenditures in 1998.

Figure 4.1: Comparative Spending for Choluteca

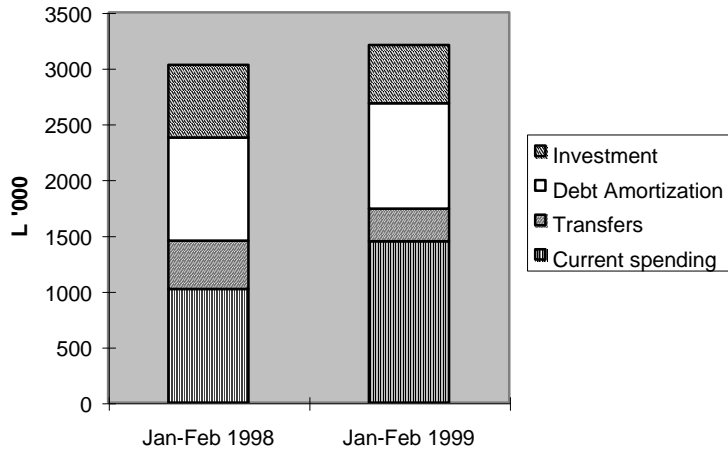
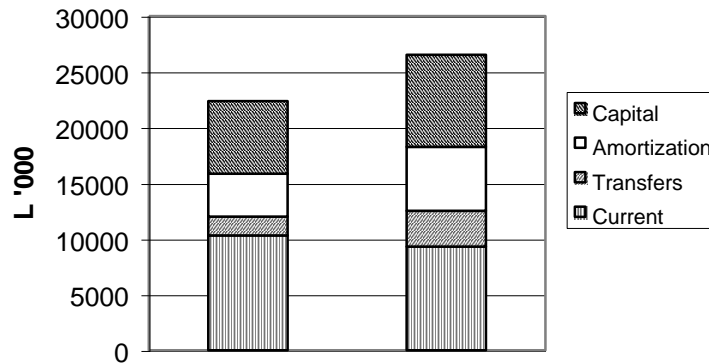
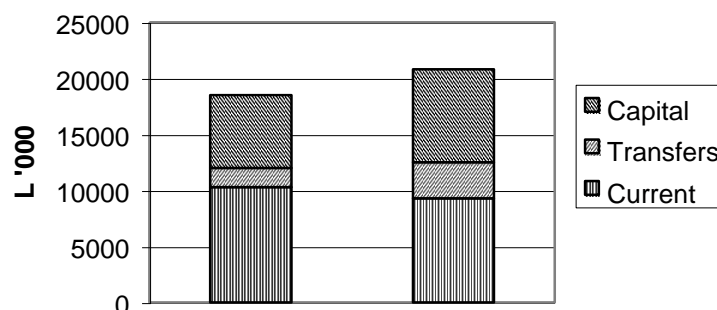


Figure 4.2: Pre- and Post-Mitch Spending Preliminary 1998 vs. Budget 1999



Although figure 5.2 compares the pre-Mitch actual spending to that budgeted for all of 1999, capital spending, transfers, and amortization are expected to increase. Figure 5.2 presents these comparative data but excludes amortization.

**Figure 4.3: Spending without Amortization
in Choluteca, Preliminary 1998 vs. Budget 1999**



It appears quite odd that the municipality of Choluteca is expecting to undertake less current spending in all of 1999 than it did in 1998. The high level of “current” spending in 1998 compared to 1999 is not a result of Mitch, since the high share of budget devoted to this type of spending had already been realized by October 1998. Transfers and capital spending are each expected to nearly double. Transfers to the fire department are normal and required by law. However, the municipality is also expecting to make large contributions to NGOs, such as the Red Cross, as part of its post-Mitch spending program.

An issue with Choluteca, as with many other municipalities, is debt outstanding and its implications for municipal finances. As of December 31, 1998, the municipality of Choluteca has five loans outstanding (see table 4.5). One is with BANMA, one is a USAID loan dating from 1992, and three are loans on a nearly commercial basis with the Banco Occidente, a private commercial bank. These loans represent outstanding balances of about L 26 million. Interest payments on the BANMA loan were canceled by a decree of Congress in January 1999.

Table 4.5: Intermediate and Long-Term Debt of Choluteca

Date of Loan	Creditor	Loan No.	Final Payment		Balance
			Date	Interest Rate	
Sep-87	BANMA	1	NA	11.3%	4,410,748
1992	USAID	2	2014	9.5%	4,327,652
Oct-97	Banco Occidente	3	2000	30.0%	2,557,867
May-98	Banco Occidente	4	2002	30.0%	14,663,376
Dec-98	Banco Occidente	5	1999	30.0%	500,000
Total					26,459,643

It is clear that debt servicing (amortizations) represent quite a burden on the municipality of Choluteca, a burden that is growing. Choluteca will need to borrow additional funds for reconstruction, and the concomitant debt burden will increase unless the municipality can negotiate debt relief.

4.3 El Progreso

4.3.1 Setting

El Progreso is situated on the northern coastal plain of Honduras, approximately 25 kilometers east of San Pedro Sula. The municipality has approximately 100,000 residents and is located in the heart of one of two major banana-producing areas on the North Coast. It depends heavily on bananas and other agricultural production (basic grains and sugar cane) for employment and municipal revenue generation.

4.3.2 Hurricane Damage and Emergency Assistance

El Progreso suffered severe damage from Hurricane Mitch, primarily from flooding of the Ulloa and Pelo Rivers. Approximately 400 homes were lost, and another 1,000 were damaged. Levees were washed out, and extensive damage was done to urban water and sewer systems, roads, and bridges. Significantly for the longer term, agricultural production within the municipality was seriously harmed, and the banana growers, in particular, have had to lay off large numbers of workers. Fear of recurring, serious flooding in this area—because of the filling of river beds with material washed down by Mitch and their consequent loss of water-carrying capacity—is causing the replanting of many plantations to be delayed, and this may result in long-term economic and financial losses for the region, including the municipal government.

El Progreso received emergency assistance through the FHIS, and the municipality is seeking the reimbursement of L 530,000 in emergency expenditures from the USAID/FUNDEMUN emergency fund. Works built by the FHIS are reported by municipal officials to cost significantly more than they would cost if the contracting and procurement processes were managed directly by the municipality, and municipal officials recommend that in future, the FHIS establish more responsive regional offices operating under a regional advisory council providing representation for the municipalities of each region. A “Municipal Development Loan and Grant fund” administered by FUNDEMUN and AMHON, as proposed in section 7, could also serve as an alternative vehicle for channeling reconstruction assistance to the municipalities.

4.3.3 Short-Term Revenue and Expenditure Impacts

Despite the serious impacts of Mitch on municipal revenues, El Progreso was able to close 1998 with collections at 88.2 percent of the year’s budgeted collections, including 87 percent of current revenue items and 91 percent of capital revenue items budgeted. Monthly collections of current revenues fell from an average of L 1.9 million before Mitch to an average of L 1.35 million after Mitch, but this was partly compensated for by an increase in capital receipts, from L 280,000 per month pre-Mitch, to approximately L 600,000 per month post-Mitch.

Monthly expenditures, which had been budgeted at an average of L 2.4 million for 1998, were L 2.4 million, 1.7 million, and 2.1 million in October, November, and December, respectively, reflecting the municipality’s efforts to contain current expenditures in line with reduced revenue collections in the post-Mitch period. Planned investments of L 9.2 million were in fact exceeded by almost L 900,000 in 1998, as a result of increased expenditures for the repair of

infrastructure needed to maintain vital public services. Current expenditures were held to slightly more than L 3 million under budget for 1998, at L 16.7 million versus 19.8 million.

El Progreso's success at reducing current expenditures is partly attributable to a reduction in municipal payroll positions, from about 360 to only 140 permanent employees. Also, the new municipal council has aggressively pursued the privatization of municipal services, having already established concession agreements with private operators for the municipal market, garbage collection, a municipal library, and a school. The council is in the process of privatizing operations of the municipal slaughterhouse and the collection of certain municipal service charges. Operating costs as a percentage of current revenues have been reduced from 82 percent to 48 percent, and the mayor has expressed his intention to further reduce operating costs to as low as 15 percent of current revenues within the next two years.

4.3.4 Current Situation and Prospects

4.3.4.1 Financial Management Performance

Revenue collections in El Progreso, unlike Catacamas, are ahead of prorated budget projections for January and February 1999. The 1999 budget was set at L 34.6 million, which means that collections of L 5.6 million would be expected during the first 59 days of the year, on a prorated basis. In fact, cumulative revenues in January and February were L 6.8 million in El Progreso, a 21 percent excess over a budget that had already been increased 19 percent over the prior year. As shown below, among major revenue items, collections of the municipal sales tax through February are 64 percent ahead of the prorated collections schedule, and, notably, collection of back taxes has already reached L 849,000 out of a total of L 1.95 million budgeted for 1999. Also unlike the municipality of Catacamas, which depends excessively on transfers and other forms of nontax revenues, local taxes and service charges make up the greatest part of revenues in El Progreso.

4.3.4.2 El Progreso Revenue Analysis

Table 4.6: El Progreso Revenue Analysis, January 1–February 28, 1999

Revenue Item	Budget 1999	% Contribution	Prorated 1/1-2/28	Collected 1/1-2/28	Collection %
Property Tax	4,100,000	11.8%	662,560	1,938	0.3%
Personal Income Tax	700,000	2.0%	113,120	186,654	165.0%
Natural Resource Extraction Tax	100,000	0.3%	16,160	13,960	86.4%
Sales Tax	7,002,000	20.2%	1,131,523	1,853,879	163.8%
Slaughter Permits	380,000	1.1%	61,408	42,189	68.7%
Sewer & Garbage Service Charges	4,170,000	12.1%	673,872	494,163	73.3%
Lease Income	1,530,000	4.4%	247,248	201,364	81.4%
Licenses & Fees	3,456,000	10.0%	558,490	1,465,811	262.5%
Sale of Goods	100,000	0.3%	16,160	-	0.0%
Other Current Income	2,890,000	8.4%	467,024	986,369	211.2%
Collection of Overdue Taxes	1,950,000	5.6%	315,120	848,805	
Collection of Overdue Charges	560,000	1.6%	90,496	73,913	
Sale of Municipal Property	630,000	1.8%	101,808	94,208	92.5%

Table 4.6: El Progreso Revenue Analysis, January 1–February 28, 1999

Revenue Item	Budget 1999	% Contribution	Prorated 1/1-2/28	Collected 1/1-2/28	Collection %
Transfers from the Public Sector	3,240,000	9.4%	523,584	249,072	47.6%
Domestic Loans	2,000,000	5.8%	323,200	-	0.0%
International Loans & Donations	292,000	0.8%	47,187	290,516	615.7%
Betterment Tax Revenues	1,500,000	4.3%	242,400	-	0.0%
Total Budgeted Revenues	34,600,000	100.0%	5,591,360	6,802,841	121.7%

4.3.4.3 Expenses for Reconstruction

While the overall budget has increased from L 29 million to L 34.6 million between 1998 and 1999, the capital budget has increased from L 10.9 to L 15.2 million, in part reflecting the increased level of local investment that will be needed for post-Mitch reconstruction. A municipal reconstruction plan has not yet been completed for El Progreso, but there is little doubt that budgeted capital expenditures—which by law can only include expenditures that have financing at the time of budget preparation—seriously understate the municipality’s total municipal investment needs. That is to say, a sizable municipal funding gap doubtless exists for post-Mitch reconstruction of municipal infrastructure in El Progreso, but that gap is not reflected in the current municipal budget. It is anticipated that a municipal reconstruction plan similar to that prepared for Catacamas will soon be available for El Progreso.

4.3.4.4 Assessment of Administrative Capabilities

El Progreso’s financial performance since Mitch and the success achieved by municipal authorities in privatizing a wide variety of municipal services demonstrate the municipality’s administrative capabilities and readiness to play a leading role in the municipal reconstruction effort.

4.4 La Ceiba

4.4.1 Setting

Situated in the department of Atlantida on the Honduran North Coast, La Ceiba is an important port serving the richest agricultural area of Honduras. Bananas, pineapple, and other high-volume agricultural exports dominate the local economy, although export assembly and tourism are also becoming important sources of employment. La Ceiba has a population of approximately 110,000 people, and it is served by an international airport.

4.4.2 Hurricane Damage and Emergency Assistance

Over 8,000 people were forced to seek emergency shelter as a consequence of Hurricane Mitch. Extensive damage was done to municipal infrastructure, in particular roads and a major bridge linking La Ceiba to San Pedro Sula, Puerto Cortés, Tegucigalpa, and other major cities of the country. Extensive bridge damage and continuing rains made overland access to La Ceiba mostly impossible between October 27, 1998, and late January 1999. La Ceiba’s air and sea

communications links were vital to its survival during this period. Secure overland access has now been restored through the erection of a so-called “Bailey bridge,” although this will have to be replaced in the relatively near future to accommodate high-traffic loads.

The municipality is providing shelter at two sites to over 500 families who lost their homes. USAID is assisting with the installation of water and sewage connections at these sites and with the construction of temporary basic units. Unlike the situation in Tegucigalpa, where transitional shelters are being constructed before relocating victims of Mitch onto permanent sites, in La Ceiba more permanent homes will be built with the assistance of PRIMHUR and several NGOs on the same sites in which they are now being temporarily housed. The FHIS has also provided substantial assistance in restoration of potable water distribution systems, and in the repair/reconstruction of school buildings and health clinics. Municipal officials report that the FHIS is delegating a high degree of authority to them in the prioritization and implementation of local projects, a situation that is quite different from that reported by other municipalities. Nevertheless, the mayor and other municipal officials believe that donor-supported reconstruction assistance would be more effective if channeled directly through municipal governments such as that of La Ceiba, which have the staff and technical resources to provide effective management at the local level.

4.4.3 Short-Term Revenue and Expenditure Impacts

As in the case of El Progreso, La Ceiba has been able to achieve a remarkably successful revenue effort since Hurricane Mitch. Only in the months of October and November did municipal revenues fall below the same months in the prior year, and total revenues in January and February 1999 are 27 percent above the same period in 1998.

Table 4.7: La Ceiba Revenue Collections Post-Mitch

	October 1998	November 1998	December 1998	January 1999	February 1999
Most recent	2,201,108	2,342,531	2,890,213	7,266,205	6,115,437
Year before	2,347,774	2,955,064	1,628,561	6,327,608	4,225,066
% Change	(6.25%)	(20.7%)	77.5%	14.8%	44.7%

On the expenditure side, La Ceiba slightly underspent the 1998 budget by about L 1 million, closing the year with cumulative expenditures of L 40.9 million. This is despite higher than average monthly expenditures during the months of November and December, which—at least in part as a result of hurricane damages—averaged L 4.7 million per month, compared to average spending of L 3.2 million per month during the prior ten months.

4.4.4 Current Situation and Prospects

4.4.4.1 Financial Management Performance

Spending during January and February 1999 remains at a high level, averaging L 4.85 million per month. This is in accord with a dramatically expanded annual budget, which has been set at L 57.7 million for the year, 38 percent higher than in 1998. Moreover, as already mentioned

above, increased spending in 1999 is being accompanied by even more rapidly increasing revenue collections, which have averaged L 6.7 million per month through February.

Table 4.8: La Ceiba Revenue Analysis, January 1–February 28, 1999

Revenue Item	Budget 1999	% Contribution	Prorated 1/1-2/28	Collected 1/1-2/28	Collection %
Property Tax	6,100,000	10.6%	985,760	698,173	70.8%
Personal Income Tax	2,000,000	3.5%	323,200	790,619	244.6%
Natural Resource Extraction Tax	150,000	0.3%	24,240	108,035	445.7%
Sales Tax	15,000,000	26.0%	2,424,000	3,618,973	149.3%
Slaughter Permits	800,000	1.4%	129,280	-	0.0%
Sewer & Garbage Service Charges	5,800,000	10.1%	937,280	2,726,250	290.9%
Lease Income	934,500	1.6%	151,015	136,874	90.6%
Licenses & Fees	3,370,000	5.8%	544,592	1,985,000	364.5%
Sale of Goods	200,000	0.3%	32,320	47,010	145.5%
Other Current Income	4,355,000	7.5%	703,768	643,136	91.4%
Collection of Overdue Taxes	2,570,000	4.5%	415,312	509,217	122.6%
Collection of Overdue Charges	1,264,000	2.2%	204,262	698,000	341.7%
Sale of Municipal Property	3,204,235	5.6%	517,804	363,377	70.2%
Transfers from the Public Sector	2,000,000	3.5%	323,200	190,135	58.8%
Domestic Loans	1,000,000	1.7%	161,600	-	0.0%
International Loans & Donations	2,000,000	3.5%	323,200	-	0.0%
Betterment Tax Revenues	6,950,000	12.0%	1,123,120	866,842	77.2%
Total Budgeted Revenues	57,697,735	100.0%	9,323,954	13,381,641	143.5%

The structure of municipal revenues in La Ceiba is relatively independent of central government transfers, with 64.5 percent of revenues originating from five main local revenue sources; namely, property taxes, sales taxes, public service charges, betterments taxes, and licenses and fees. Loans and transfers make up only 8.7 percent of budgeted revenues for 1999.

The 1999 budget includes L 17.1 million in construction and improvements, up from L 14.0 million the year before. As in the case of El Progreso, the 1999 budget for La Ceiba does not fully reflect the impact of post-Mitch reconstruction on required capital spending within the municipality, as much of the reconstruction effort is being absorbed by the central government and NGOs, and established municipal budget procedures in Honduras proscribe the inclusion of any unfunded expenditures. Thus, a reliable estimate of the municipal funding gap for Mitch reconstruction in La Ceiba will have to await the completion by FUNDEMUN and the municipality of the municipal reconstruction plan, which is expected shortly.

4.4.4.2 Assessment of Administrative Capabilities

As in the case of El Progreso, impressive financial management performance and a history of successful implementation of sizable local investment programs attest to the ability of the municipal government to perform efficiently and to its potential to contribute to the post-Mitch reconstruction effort. Direct implementation of donor-financed programs should be considered for La Ceiba, with the provision of technical assistance in specific areas, such as hydrological

engineering and tourism development, that were mentioned during the study team's interviews with the mayor.

4.5 La Lima

4.5.1 Setting

La Lima is a relatively small (166 square kilometer) but densely-populated (88,500 inhabitants) municipality that is located close to San Pedro Sula. Historically, La Lima has been the major banana-producing center of Honduras, with the Tela Railroad Company (United Brands) and numerous independent growers continuing to provide the major source of employment in the municipality. The terrain in the municipality is flat and low-lying. It is crossed by the Chamelecón, Chotepe, and Chasnigua rivers and has become increasingly susceptible to flooding in recent years.

4.5.2 Hurricane Damage and Emergency Assistance

Hurricane Mitch caused the worst flooding in La Lima's recorded history, inundating about 98 percent of the municipal land area to depths of several feet. The main terminal building of the San Pedro Sula international airport, located on the outskirts of the town of La Lima, was flooded to a depth of over five feet for several days, as were runways and taxiways, forcing the closure of this facility for several weeks. Large areas of banana plantations were similarly damaged, with a significant percentage of these ultimately having to be replanted. The largest grower, Tela Railroad Company, reported losses of over US\$1.2 million and has had to temporarily lay off 70 percent of its work force, or about 5,000 employees. The economic repercussions of such a large loss of employment are felt throughout the municipality, not least in the short-term loss of municipal revenues.

A large export processing operation (ZIP Continental) suffered severe damage and losses reported at L 57 million. About 107 other small and medium-size enterprises in La Lima also reported significant losses, totaling approximately L 65 million (US\$4.6 million).

Municipal officials report approximately 400 homes destroyed and another 1,000 severely damaged by the floods. Several school buildings and health care facilities were damaged or destroyed; most of the municipal water and sewage system was severely damaged; and large areas of the city of La Lima continue to be without service due to the clogging of pumps, collectors, and pipes with mud and other debris. In many areas of the city, mud accumulated to over 1 meter in depth and has been removed only at great cost and effort.

Perhaps of greatest long-term concern, the municipality lost over 11 kilometers of levees that had been erected to contain the flow of major rivers that continue to be prone to flooding. Indeed, the likelihood and severity of future flooding has increased after Mitch, as river beds have filled up with sediment and now have only a fraction of their prehurricane water-carrying capacity.

Emergency assistance to La Lima was provided primarily through the FHIS, which is reported to have expended approximately L 16 million in repairs and emergency reconstruction efforts. The FHIS's efforts have been concentrated on emergency relief measures, however, and the permanent reconstruction of major municipal infrastructure systems has yet to be initiated.

4.5.3 Short-Term Revenue and Expenditure Impacts

Total receipts fell dramatically to only L 391,000 in November 1998, down from the approximately L 1.2 million monthly average during the previous ten months before Hurricane Mitch. Receipts recovered relatively quickly, however, to L 1.2 million in December.

Total expenditures also fell in November, although less dramatically, to L 923,000 from a monthly average of L 1.1 million up to that point. Expenditures then surged in December to L 3.1 million, with about L 1 million of the increment accounted for by increased (emergency) construction expenses, and another L 1.3 million by increased transfers, which were, again, largely devoted to emergency relief.

4.5.4 Current Situation and Prospects

Unlike in the other municipalities visited, municipal offices themselves were flooded and severely damaged in La Lima, with a total loss of computers and a large part of the municipality's physical files. A new municipal office building is nearing completion, which should help to relieve the situation, but for the moment municipal officials continue to work under highly inadequate conditions. Much work remains to be done to restore municipal systems and recover lost data, so that normal accounting and budgeting processes can be restored. As of the team's visit, many of these functions were still being conducted by hand, and the municipality was not able to provide any accounting or budget data for 1999 whatsoever.

For this reason, in addition to sharp cutbacks in municipal personnel from 165 in early 1998 to only about 70 employees at present, it is felt that adding significantly to La Lima's administrative burdens would not be advisable at this time. It is recommended, therefore, that plans consider the active involvement of the FHIS and other outside agencies for the implementation of post-Mitch reconstruction programs in La Lima, at least during the near term. It is also considered that significant technical assistance support will be needed to assist La Lima in reestablishing its own internal operations to a satisfactory level of efficiency during the next year.

4.6 Small, Remote Municipalities

The five case studies presented above all describe medium-sized municipalities, whose situation is quite different from that of small, remote, poor municipalities. To gain a better understanding of the overall impact of Mitch, team members interviewed mayors from four municipalities on the Northeast Coast: Santa Fé, Santa Rosa de Aquan, Limón and Irióna (all in Colón Department). These small coastal communities were severely damaged by the hurricane. Their highest priority is for reconstruction and repair of roads, bridges, and communications. The mayors stated that they have received very little assistance to date because of their remote

locations. They fear that the situation will become much worse during the approaching rainy season. These communities are mainly populated by Hondurans of African descent and are among the poorest in Honduras. USAID/Honduras and AMHON are currently holding a series of meetings with mayors of these communities to help them with their reconstruction efforts.

5 POST-MITCH RECONSTRUCTION PLANS

5.1 National Reconstruction Plan

The National Reconstruction Plan had not been completed by the end of the study period. However, the GOH did make a verbal presentation of the preliminary plan to the study team. The GOH estimates that the cost for reconstruction will be approximately US\$5.0 billion. The plan includes statements in support of decentralization and passes responsibility for the reconstruction of infrastructure, housing, schools, and health facilities to the municipalities.

5.2 Municipal Reconstruction Plans

Immediately following the hurricane, AMHON prepared a preliminary assessment of the impact of Mitch on its member municipalities. Approximately 100 out of a total of 298 municipalities suffered substantial damage from Mitch. AMHON has also prepared a Municipal Reconstruction Action Plan for 1999–2000. The plan lists the major impacts of Mitch at the local level as:

- Injury to individuals - loss of employment, disease, trauma, discouragement
- Social infrastructure (schools, health facilities, housing)
- Infrastructure (water, sewer, roads, bridges)
- Environmental (forest, watersheds, river beds)
- Productive sector (factories, businesses, crops).

It lists some of the current concerns of the municipalities:

- Change in attitude of the central government away from decentralization
- Lack of participation by the municipalities in the planning and decision-making process for reconstruction
- Resurgence of emergency legislation for the reconstruction work, which reduces the previous legal basis for municipal autonomy and authority
- Uncertainty of the future payments by the central government of the 5 percent revenue transfer (see section 3.3.1).

The AMHON action plan lists specific actions that it will take:

- Lobby the national congress to discourage legislation harmful to the decentralization process
- Meet with the reconstruction cabinet and international organizations to gain support for continuing decentralization as part of the transfer of resources for reconstruction
- Undertake promotional campaigns to strengthen local democracy and to promote central government payment of the 5 percent revenue transfer
- Implement a simplified cadastre (real property registration system) in 100 municipalities to update information, improve collection of property tax, and increase municipal revenues
- Conduct training on health and environmental issues
- Assist 25 municipalities with preparation of master plans and related regulatory land use codes
- Prepare and present technical guides and manuals for municipal implementation of reconstruction activities
- Strengthen department (state) and regional level support for municipal development.

None of the 100 municipalities affected by Mitch have yet prepared comprehensive reconstruction plans. Part of the reason for the delay is the uncertainty about the National Reconstruction Plan and about the roles that the central government will assign to the national level agencies and to the municipalities. Other reasons are the lack of financial resources and the uncertainty of the timing and quantity of funding from international sources.

5.3 USAID and Other Donor Support Plans

USAID/Honduras and other donors have made a substantial contribution to the emergency relief effort and have started to provide assistance for reconstruction even though the GOH has not yet presented its National Reconstruction Plan. Details on USAID support will become available after the GOH announces its national plan and after the U.S. congress acts on the supplemental appropriation for U.S. assistance. Preliminary USAID plans include support for reconstruction and repair of infrastructure and housing and for restoration of the productive sector.

5.4 Costs

At present, there is no comprehensive estimate of the total funds the municipalities will need to carry out the responsibilities that the central government is assigning to them in the preliminary version of the National Reconstruction Plan (housing, health facilities, schools, water, sewer, streets, and bridges). After the National Reconstruction Plan and the municipal plans have been completed, the estimated amounts will be known, and calculations can be made for the gap between funds available from Honduran sources (local and national) and the amounts needed from international sources. It can be assumed that if the total national impact is \$5.0 billion, all will be spent within the municipalities. The main question is how much will be implemented by the municipalities and how much by the central government through its agencies.

6 SUMMARY OF FINDINGS

6.1 National-Level Impact of Mitch

Even before Mitch struck, the GOH was facing a difficult but improving fiscal situation. Foreign debt amounted to about \$4.4 billion, with half owed to multilateral lenders and the other half to foreign governments. In 1998 interest payments on this debt amounted to slightly more than 20 percent of current spending, and fresh funding only slightly exceeded the repayment of principal on these foreign loans. Total debt service as a percentage of exports has declined steadily from 33 percent in 1995 to 20 percent in 1998. The GOH has been prudent in not borrowing from domestic sources, and the new Central Bank law no longer permits the GOH to fund its budget from Central Bank overdrafts. The GOH included \$57 million in domestic bond authority in its proposed 1999 budget but is hoping that it will not have to tap this source of credit, mainly because of the likely destabilizing impact on prices and interest and exchange rates.

An accurate estimate of the financial impact of Mitch at the national level is not yet available. The most recent GOH estimate (March 20, 1999) of the total cost for recovery and reconstruction is \$5.0 billion, up from \$2.7 billion in December 1998. The GOH estimates that 70 percent of the impact was in the productive sector, 17.3 percent in infrastructure, 11 percent in the social sector (housing, health facilities, and schools), and 1.7 percent in the environment. The current version of the GOH 1999 budget includes only about \$275 million for reconstruction. Until the National Reconstruction Plan is made available, it is not possible to understand how the 1999 budget will fit into the overall plan for reconstruction. It is clear, however, that the GOH contribution for reconstruction will only be a small part of what is needed. The GOH is anticipating that most of the cost of reconstruction will be covered by external grants, loans, and debt forgiveness.

The central government has stated that the municipalities will be responsible for the reconstruction of the social sector. However, it has not announced that it will provide funding for this effort and has not confirmed that it will transfer the full 5 percent of tax revenue to cover municipal administrative expenses. In 1998 only 1 percent of revenue was transferred from the central government to the municipalities. These transfers are vital to continued decentralization because they allow the municipalities to carry out their local responsibilities.

Much of the GOH reconstruction effort will be implemented through the national level agencies, such as the FHIS, whose past methods of operation have not contributed to decentralization.

Prior to the hurricane, Honduran external debt indicators did not reach the thresholds required for eligibility under the Heavily Indebted Poor Countries Initiative. In the wake of the hurricane, the staffs of the IMF, World Bank, and Inter-American Development Bank have begun work on a comprehensive reassessment of the country's debt situation and prospects for debt relief in the context of the initiative. The government is currently negotiating with foreign donors and others to reduce the country's debt servicing burden for the next few years. Bilateral

lenders have already agreed to suspend interest payments for the next three years. However, there has been no discussion with the municipalities about debt relief for them.

The IMF has approved a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) for Honduras in an amount equivalent to Special Drawing Rights (SDR) 156.75 million (about US\$215 million) to support the government's economic program for 1999-2001. The first annual loan, equivalent to SDR 76 million (about US\$104 million), will be available in two semiannual installments, the first of which, equivalent to SDR 59.85 million (about US\$84 million), will be available on April 12, 1999.

6.2 Municipal-Level Impact of Mitch

Approximately 100 of the 298 municipalities in Honduras suffered damage from Hurricane Mitch. The extent and nature of damage suffered in different areas of the country varied tremendously, with different implications for short-term emergency expenditures, the amount of capital investment needed for reconstruction, and long-term effects on the local economy and tax base. Some municipalities were only mildly affected, while whole communities in others were completely devastated. In addition to the physical damage to infrastructure, Mitch had a severe impact on some productive sectors (e.g., bananas and shrimp farms).

Many of the municipalities were completely isolated during the first few weeks following the storm and quickly used all their available cash and other resources to provide emergency relief for their citizens. As a result, some of the municipalities have been forced to reduce administrative staff at a time when their workload has dramatically increased for the relief and reconstruction activities. USAID/Honduras and OFDA responded to this critical situation by providing (1) reimbursement, through AMHON, of emergency expenses to 20 of the municipalities that suffered the most from Mitch; (2) repair of emergency water systems through the FHIS; (3) clearing of debris, cleanup and road building, also through AMHON; (4) construction of transitional shelters in eight municipalities for displaced persons; and (5) assistance to NGOs and municipalities for the construction of permanent housing for victims of Mitch. In addition to the assistance from USAID, many municipalities have received assistance from other donors and from NGOs for reconstruction activities.

At the municipal level, the normal budget preparation process was completely disrupted by Mitch, and 1999 budgets are still being revised almost daily as more detailed information becomes available on reconstruction costs and the impact of Mitch on normal revenue and expenses. Most municipalities have not yet completed detailed estimates of the damage or the costs for reconstruction. However, all have a list of priority projects with at least preliminary cost estimates. Some are starting to prepare reconstruction plans with assistance from USAID through FUNDEMUN.

All five municipalities visited by the team (Catacamas, Choluteca, El Progreso, La Ceiba, and La Lima) are receiving assistance from USAID, AMHON, FUNDEMUN, and other agencies. Each has suffered extensive damage and loss of life. However, they are making remarkable progress in the transition from the emergency relief phase to the reconstruction phase. All five have reestablished their revenue base, and in some cases their revenues have actually increased

during the months after Mitch. They accomplished this by a combination of actions including, privatization of some services, more efficient collection of taxes and fees, higher rates of collection of certain taxes related to the reconstruction activity, and stepped-up collection of past due taxes. Although the increase in revenues is a positive indicator, the actual amount of increased revenues is small when compared to reconstruction needs. The municipalities desperately need funds from the central government, international donors, and NGOs to meet the urgent need for shelter and services before the next rainy season. They also need assistance in preparing longer-range reconstruction plans and a continuation of support to improve their administrative capability.

There is a sharp contrast between conditions in the five municipalities visited by the team and those in the four smaller, poorer, remote municipalities (Santa Fé, Santa Rosa de Aguan, Limón, and Iriona) on the Northeast Coast. These communities lost their houses, bridges, roads, electrical power, and communications. According to the mayors, these municipalities had not received any assistance from the central government as of early March. USAID and AMHON are working with these municipalities to be sure that they are included in the reconstruction effort.

The debt burden of many municipalities is substantial, and the burden is growing (see the example of Choluteca's debt in section 4.2.3.2) The municipalities need assistance in meeting with their creditors and in negotiations with the central government for relief of their debt if they are going to meet their responsibilities in the reconstruction effort.

7 SUMMARY OF ISSUES AND RECOMMENDATIONS

7.1 Decentralization Policy

7.1.1 Issue

There are indications that central government support for decentralization is weakening, and there is some fear that a large influx of funding for reconstruction through the central government could undermine the remarkable progress that Honduras has made toward decentralization during the past ten years.

Many mayors and others involved in municipal development perceive that building democracy at the local level is not currently a high priority for the central government. Indicators include: (1) lack of participation of municipalities in reconstruction planning, (2) lack of municipal participation in implementation of community level infrastructure projects sponsored by the FHIS and other central government agencies and (3) failure of the central government to transfer the 5 percent (required by the 1990 Municipal Reform Law) of tax revenue to the municipalities.

7.1.2 Recommendations

- Funding for reconstruction projects from external donors should include conditions that support a continuing decentralization process, support for democratic participation at the

local level, and an increased role of local governments in providing public services to their citizens.

- International donors should encourage the GOH to transfer the full amount (5 percent) of central government tax revenue to the municipalities as required by the 1990 Municipal Reform Law. Lack of this funding is working against decentralization and severely restricts the capability of local governments to respond to reconstruction needs.
- Donors should sponsor workshops and seminars to review the relative strengths and weaknesses of municipal governments vis-à-vis the central government and the interaction between the two levels of government. One objective would be to highlight those areas where local governments can be especially effective in the implementation of reconstruction projects. A second objective would be to increase awareness of the danger to the process of decentralization if the central government agencies (such as the FHIS, SANAA, and SOPTRAVI) push aside local governments during reconstruction.

7.2 Preparation of National Reconstruction Plan

7.2.1 Issue

The central government has not involved the municipal governments, AMHON, or FUNDEMUN in the preparation of the National Reconstruction Plan, even though the plan passes major responsibility to the municipalities for reconstruction of housing, schools, health facilities, and infrastructure.

7.2.2 Recommendation

Donors should encourage greater participation by the municipalities in planning and implementation of reconstruction projects and should consider channeling funds in a manner that ensures their participation.

7.3 Funding Channels and Implementation of Reconstruction Projects

7.3.1 Issue

There is a direct relationship between how funds are channeled and the role that municipalities can play in the implementation of reconstruction projects. The FHIS and other national agencies currently implement most infrastructure projects. The mayors contend that FHIS projects are extremely expensive, take much too long to complete, are not subject to local scrutiny, and undermine their role as providers of public services.

7.3.2 Recommendations

- Donors should review the policies and procedures of the FHIS to confirm that they support decentralization and do not have a negative impact on efforts to strengthen municipal governments. The review should include an assessment of the administrative and management capacity of the FHIS and the efficiency of its implementation of infrastructure projects within the municipalities. The absorptive capacity of the FHIS should also be assessed, considering

the large amounts of new funding expected to be channeled through the FHIS during reconstruction.

- Consideration should be given to the creation of a new funding channel by establishing a Municipal Development Loan and Grant Fund administered by FUNDEMUN and AMHON for small projects in the \$10,000 to \$50,000 range. Municipalities would have access to the fund based upon the “grade” they receive for their administrative capacity (see below). The implementation of the small capital projects should be used as a learning experience for the municipalities and should be linked to training and technical assistance directed at increasing their management and administrative capacity.

7.4 Grading System for Municipal Administrative Capacity

7.4.1 Issue

The FHIS grading system is apparently not being used as intended to grade the level of administrative capacity among the municipalities. The intention was that those receiving a higher grade should have more authority and independence to implement projects. Interviews with mayors of “A” rated municipalities indicate that they have little or no authority to act in projects funded by the FHIS.

7.4.2 Recommendation

FUNDEMUN should act as a certifying agency to confirm the appropriate grade for each municipality. At the same time FUNDEMUN should identify training and technical assistance needed to correct deficiencies and to help a municipality move up to a higher grade. The improved grading system would help funding organizations to determine the municipalities’ appropriate level of participation in the implementation of reconstruction projects.

7.5 Municipal Financial Systems

7.5.1 Issue

The current system for budgeting, accounting, and reporting of municipal revenues and expenditures has a number of deficiencies and does not conform to international standards for government financial management. Financing from loans or sale of bonds is classified as “revenue,” giving the impression of balanced budgets. Some of these deficiencies arise from the 1990 Municipal Reform Law. Because financing and amortization are included as either revenue or expenditure, it is not possible, without considerable investigation, to determine whether municipalities are running deficits or surpluses, or to determine their sustained revenue efforts versus normal current spending. No overall balances are available, nor is there any accounting for a current account balance. In addition, reporting of municipal finances is inadequate and should be expanded.

7.5.2 Recommendation

The sections of the 1990 law governing municipal finance should be revised to conform with international norms for government finance statistics, and municipal financial systems should be revised to meet international standards.

7.6 Municipal Debt

7.6.1 Issue

The GOH has made sound arguments explaining why its debts to international lenders should be forgiven as part of the support for reconstruction. The same arguments are valid for the debts that municipalities have to CABEI, international organizations, and BANMA.

7.6.2 Recommendation

The GOH, AMHON, and FUNDEMUN should assist the municipalities in a review of their debts and arrange a “Debtors’ Conference” where municipalities can make the case for municipal debt forgiveness as part of the overall forgiveness of national debt.

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ATTACHMENT B

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