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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

TAX ADMINISTRATION INSTITUTIONAL AND OPERATIONAL STRENGTHENING

(HO-L1108)

LOAN PROPOSAL

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ABBREVIATIONS

AWP	Annual work plan
CIAT	Inter-American Center of Tax Administrations
DEI	Dirección Ejecutiva de Ingresos [Revenue Office]
ECLAC	Economic Commission for Latin America and the Caribbean
FAD	IMF Fiscal Affairs Department
GDP	Gross domestic product
GTI	Gerencia de Tecnología de la Información [Information Technology Office]
ICEFI	Instituto Centroamericano de Estudios Fiscales [Central American Tax Studies Institute]
IMF	International Monetary Fund
ISV	Impuestos sobre ventas [Sales taxes]
OVE	Office of Evaluation and Oversight
PCU	Program Coordination Unit
RTN	Registro Tributario Nacional [National Tax Registry]
RTNs	People with tax registry numbers
SAR	Servicio de Administración de Rentas [Revenue Administration Service]
SARAH	Sistema Automatizado de Rentas Aduaneras de Honduras [Automated Customs Revenue Service of Honduras]
SCF	Single Currency Facility
SEFIN	Ministry of Finance
SIAFI/UEPEX	Sistema de Administración Financiera Integrado/ Unidades Ejecutores de Proyectos con Fuente Externa [Integrated Financial Administration System/External Loan Executing Units]
UOM	Unidad de Organización y Métodos [Organization and Methods Unit]

PROJECT SUMMARY
HONDURAS
TAX ADMINISTRATION INSTITUTIONAL AND OPERATIONAL STRENGTHENING
(HO-L1108)

Financial Terms and Conditions

Borrower: Republic of Honduras					
Executing Agency: Dirección Ejecutiva de Ingresos [Revenue Office] (DEI) and, upon approval of executive decrees, Servicio de Administración de Rentas [Revenue Administration Service] (SAR)				**OC**	**FSO**
			Amortization period:	30 years	40 years
Source	**Amount (US$ million)**	**%**	**Disbursement period:**	5 years	5 years
			Grace period:	6 years	40 years
IDB Ordinary Capital (OC):	16.2	40.5	**Inspection and supervision fee:**	(a)	N/A
IDB Fund for Special Operations (FSO):	10.8	27.0	**Interest rate:**	SCF-fixed[b]	0.25%
Local:	13.0	32.5	**Credit fee:**	(a)	N/A
Total:	40.0	100	**Approval currency:**	U.S. dollars	

Project at a Glance

Project objective/description: The principal objective of the program is to improve tax revenue levels in order to create the fiscal space needed to finance priority expenditures. The program supports the Honduran government's decision to restructure tax and customs administration, for which purpose it is creating the SAR to replace the current DEI. This support will be provided through: (i) the revision and updating of taxation processes in accordance with the Honduran legal framework; (ii) modernization of the SAR's technological infrastructure and systems; and (iii) strengthening of the SAR's human resources.

Special contractual conditions precedent to the first disbursement: (i) approval, to the Bank's satisfaction, of executive decrees providing, respectively, for the elimination of the DEI and the creation of the SAR to replace it; (ii) the entry into force of a subsidiary agreement between the borrower, represented by the Ministry of Finance (SEFIN) and the DEI (the SAR, upon approval of the aforementioned decrees), transferring resources and obligations for executing the project; (iii) creation of the program coordination unit; (iv) implementation of the Integrated Financial Administration System/External Loan Executing Units (SIAFI/UEPEX) module; and (v) confirmation by the borrower, via legal opinion, of the validity of its obligation with respect to the local contribution (paragraph 3.4).

Special conditions for execution: (i) creation of a special separate account for managing the local counterpart, in which funds to reimburse retroactive financing will be deposited, which will be used exclusively to finance such local counterpart (paragraph 3.9); and (ii) financing for the layoffs provided for in Component III of the program, subject to the Bank's receiving evidence that such layoffs comply with: (a) the criteria and requirements established in the program; (b) legal and constitutional provisions in effect in the country; and (c) pertinent legal and administrative labor-related procedures and standards as applicable (paragraph 3.5).

Exceptions to Bank policies: None.

The project qualifies as: [c] SV ☑ PE ☐ CC ☐ CI ☐

(a) The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans.

(b) The borrower will pay interest on outstanding balances on this portion of the Ordinary Capital loan at a LIBOR-based rate. The rate on the outstanding balance will be set whenever such balance reaches 25% of the approved net amount or US$3 million, whichever is greater.

(c) SV (Small and Vulnerable Countries), PE (Poverty Reduction and Equity Enhancement), CC (Climate Change, Sustainable Energy, and Environmental Sustainability), CI (Regional Cooperation and Integration).

I. PROJECT DESCRIPTION AND RESULTS MONITORING

A. Background, problems, and rationale

1.1 The 2008-2009 international financial crisis affected Honduran economic performance and trade momentum. As a result, the economy slowed over the 2010-2014 period (average growth of 3.5%) compared with the 2004-2007 period (when it averaged 6.3%). The external accounts remained weak, but showed a recent favorable trend with the current account deficit falling from 9.5% of GDP in 2013 to 7.4% of GDP in 2014. Inflation remained under control (5.8% in 2014, within the range established by the central bank).

1.2 The slowdown in economic growth, political events, and weaknesses in the management of fiscal policy put pressure on the performance of public finances. The central government's fiscal deficit grew from 2.9% of GDP in 2007 to 7.9% in 2013.[1] Public debt increased from 19.3% of GDP in 2007 to 42.6% of GDP in 2013. Total expenditures went from 22% of GDP in 2007 to 24.8% of GDP in 2013. However, during the 2009-2013 period, tax revenues did not exceed 15.3% of GDP, below the level of taxes collected prior to the international crisis (16.4%, 2007) and below the average for Latin America (16.4% of GDP in 2013).

1.3 Honduras's principal sources of tax revenue are sales taxes and income taxes, representing 41.5% and 32% of total tax revenues in 2014, respectively. Half of the sales tax revenue comes from imports. The tax system's lack of productivity (for example, income tax intake from individuals is 1.6% of GDP)[2] and numerous tax benefits granted to different sectors of the economy (7% of GDP) affect the country's tax intake.[3]

1.4 The imbalance in public finances limits fiscal space for investing in the country's neediest areas and for maintaining social spending. The incidence of poverty in Honduras increased from 58.8% in 2009 to 64.5% in 2013, while high income disparity persists (Gini coefficient of 0.57).[4]

1.5 **The fiscal sustainability strategy.** Between 2010 and 2012, the Government of Honduras implemented tax reforms to increase tax revenue.[5] However, the effects were not as expected because of the weaknesses in tax administration. In this context, through the 2014-2018 Government Plan, the government has been implementing fiscal discipline measures to ensure that the country generates the resources necessary to finance priority expenditures.[6] In 2014, the authorities

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[1] The consolidated public sector deficit increased from 1.6% of GDP to 7.6% of GDP between 2007 and 2013.

[2] For every point of the rate, 0.07 points of GDP is collected. Income tax productivity is calculated by dividing the amount collected by the tax as a percentage of GDP by the weighted average rate of the tax. For individual income tax, the productivity is 0.549 points of GDP in the OECD. Díaz de Sarralde (2012).

[3] Gómez, J., M. Pecho, and D. Morán (2012). *Los gastos tributarios en Honduras*. SEFIN, IDB, and CIAT.

[4] World Development Indicators.

[5] See *Reformas Fiscales en América Latina: El Caso de Honduras* (ECLAC and ICEFI, 2013).

[6] The 2014-2018 Government Plan (Everyone for a Better Life) establishes as an outcome reducing the central government's fiscal deficit to 2.5% of GDP by the end of the administration's term.

implemented the reforms approved in 2013 to reduce public spending and increase revenue, including raising the general sales tax rate from 12% to 15%.[7]

1.6 As a result, in 2014 the fiscal deficit fell to 4.4% of GDP;[8] public borrowing slowed; the rising trend in public spending was reversed (23.1% of GDP); and the tax ratio reached 16.3% of GDP, a level similar to that of 2007 (with a sales tax rate three percentage points lower) and to the average for Latin America. Current intake is still insufficient. One of the government's key efforts to sustain and increase tax revenue consists of structural reform of tax and customs administration management, including the creation of the Revenue Administration Service (SAR) to replace the current Revenue Office (DEI).[9]

1.7 The DEI has experienced a high level of institutional instability as evidenced by high turnover among high- and mid-level officials. Over the last 20 years, Executive Directors have remained in their positions for an average of 1.7 years.[10] This has led to slow progress in implementing modernization processes. Nonetheless, the DEI's customs area dealt with the modernization of its procedures and control systems, as well as improvement of the operational infrastructure and strengthening of the ex post audit and risk analysis areas with new specialized professionals.

1.8 The restructuring of the DEI is part of the government's efforts to optimize public administration.[11] The Centralized and Decentralized Public Administration Reform Commission, created by Decree PCM-028-2013, has carried out restructuring processes in various institutions that have been given priority.[12] It is noteworthy that when the Honduran government requested Bank support for tax administration reform, the decision to create the SAR to replace the current DEI had already been made. The Bank's team held various discussions on the subject and, based on the experience of various countries in the region (see paragraphs 1.17 and 1.18), the Bank agreed to assist the government with its reform. The main arguments for the reform are: (i) the need to implement a new human resources policy and to recover the corporate image of the tax administration by decoupling its name from the DEI gave rise to the creation of the SAR; (ii) the proven need to replace a large part of the tax administration's technical staff (see paragraph 1.13b); and (iii) significant evidence of the lack of transparency and integrity in key areas of the tax administration (see

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7 Law Governing Public Finances, Control of Exemptions, and Anti-evasion Measures (278-2013, 21 December 2013). These measures facilitated adoption of the stand-by agreement with the IMF.

8 The consolidated public sector deficit fell to 4.3% of GDP in 2014.

9 The drafting of executive decrees for reform of tax administration is now in its final stage, in coordination with the Public Administration Reform Commission. As part of this reform process, the DEI would be eliminated and the staff from the Customs Revenue Division would be temporarily incorporated into SEFIN until the SAR is up and running. By decree of the Cabinet Secretaries, the President may order the creation, modification, or elimination of public administrative units (Decree PCM-266-2013). Failure to approve such decrees would impede the execution of this program and thus progress in strengthening the country's tax administration (as per the condition for execution indicated in paragraph 3.5).

10 For internal tax chiefs, 2.85 years and for customs, 2 years.

11 See Decree PCM-266-2013 and Decree PCM-028-2014.

12 In the context of structural reforms of public companies and entities, plans have proceeded for the voluntary retirement and termination of employees at Hondutel and the Empresa Nacional de Energía Eléctrica [national electricity company], as well as for the elimination of the Honduran Institute for Children and Families, with the layoff of all staff and the creation of a new entity to replace it.

paragraph 1.13b). The high risk that newly hired staff would become contaminated contributed to the decision to replace all staff.

1.9 **Problems and their causes.** The main problem is a tax collection level that is insufficient to sustainably finance public spending needs in priority areas.

1.10 The specific problems that exacerbate the main problem are: (i) ineffective tax procedures for carrying out tax administration management in accordance with the Honduran legal framework; (ii) weakness in the production of reliable and timely information for effectively auditing and collecting from taxpayers; and (iii) lack of professional development of human resources for carrying out the tax administration's institutional mandate. The causes associated with these three specific problems are presented below.

1.11 First, ineffective tax processes.[13] The principal causes associated with this problem are:

a. **Registration.** National Tax Registry (RTN). The taxpayer registration process does not have the basic information for proper management of taxpayers and the existing information contains many inconsistencies and errors.[14] This contributes to making the Honduran tax system's tax base fall well below international standards. Of a total of 893,904 individuals registered in the RTN, only 107,454 (only 12.2%) are active. The ratio between active taxpayers and the economically active population is 2.7%, a percentage that is well below the regional average (21%).[15]

b. **Tax returns.** The procedures for managing the taxpayers' current accounts[16] are deficient in terms of the processes for loading tax returns and payments to the Tax System (eTAX) and in how they are recorded. Complex cleanup activities are carried out to identify omissions and balances owed, resulting in the inefficient use of auditors' time (International Monetary Fund, Fiscal Affairs Department (FAD), page 17).[17] Only 62,523 returns were recorded in the system out of a total of 893,904 in the RTN (6.9%).[18]

c. **Invoicing.** The procedure for reviewing the sales tax credit notes (invoices) is documentary but there is no review of the basic documentation that generates the invoices (FAD, page 19). In 2013, only 16,831 invoices were issued by the taxpayers in the eTAX out of a total of 893,904 registered in the RTN, representing 1.9%.

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[13] The exception is the DEI's customs area, where control systems and procedures were reengineered under earlier operations with the Bank.

[14] Paper forms are used to register in the RTN and update data. There is duplication of taxpayers with different identifications and the RTN is not checked against the national population registry and public records (FAD, page 21).

[15] See The State of Tax Administrations in Latin America: 2006-2010, (IDB, CAPTAC-DR, CIAT, 2013).

[16] The taxpayer current account presents taxpayer information on registration, tax returns and invoices, payments made, adjudicated tax debt, as well as refunds received.

[17] As there are various subsystems with databases that are not integrated, and there is no automated tool for cross-checking and validating information, auditors have to check the information in various databases manually and on an individual basis and without standardized criteria. This takes a lot of time and lowers productivity. To a large extent, the preparation of this operation has been based on the most recent diagnostic of the IMF, *Elementos Estructurales para el Fortalecimiento de la DEI*, FAD, 2014.

[18] DEI presentation.

d. **Auditing.** The auditing capacity of the Large Taxpayers Administration is inadequate. There is limited comprehensive audit coverage and a large part of the auditor force is directed to performing preventive audits (FAD, page 29).[19] In 2013, only 51 comprehensive audits were conducted of a total of 602 large taxpayers (8.5%).[20] The likelihood of being audited is very low, meaning that each large taxpayer might be audited once every 11 years (FAD, pages 18-19).

e. **Collection.** The organizational structure of the DEI is inadequate for effective control of the collection of taxpayers' tax obligations. The DEI has no unit providing legal support to the prosecutor's office for enforced collection (FAD, page 20). In 2013, the tax administration lost all 46 enforced process cases, many of them because the statute of limitations had expired or the taxpayers could not be located (DEI, FAD, page 27).

f. **Organization and Methods Unit (UOM).** This unit is responsible for coordinating the reengineering of procedures. Its staff was recently assigned but does not have sufficient capacity to lead a change process of this magnitude.

1.12 Second, weaknesses in tax information management tools.[21] The principal causes associated with this problem are:

a. **Transactions.** There are many transactional systems in operation that are not integrated. In addition, most of the systems have been developed using different and obsolete technologies.[22] It is very difficult to correct or add functionality to these systems or to integrate them. In addition, only three of the nine current applications have supporting documentation for maintenance (eTAX, Automated Customs Revenue Service of Honduras (SARAH), Auditax 1).

b. **Functionalities.** The information technology systems do not have adequate validation of data entering through the traditional channels. Only 47% of tax returns are filed electronically (FAD, page 25). Returns and payments are submitted to separate agencies, leading to errors that significantly impact the quality of the taxpayer current account (for example: corrected returns loaded into the system do not always update information stored in the databases); the error percentage may be as high as 40% (FAD, page 26).

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19 Preventive (ex ante) audits consider an event occurring at a given point in time, and most often involve taxpayers who in principle present no tax risk. Comprehensive (ex post) audits are used for combating complex forms of tax evasion and fraud and are performed on a priority basis with respect to taxpayers who present some tax risk. The preventive audit is a way to offset weak fraud identification after the occurrence of the event, due to a lack of information and risk management tools. Ex post audits generate more efficient use of auditor' s time and produce better results.

20 This is the result of the auditors' low technical capacity, in addition to the lack of basic information on taxpayers' risk.

21 The main instruments for managing tax information are: systems, applications, data validation mechanisms, databases, staff responsible for data management, and the technological infrastructure where the data are managed.

22 Notably: (i) eTAX; (ii) Integrated Tax System (SIT); (iii) File Control System (CONEX); (iv) the vehicle tax collection system, Ifénix Returns Loader; (v) traditional filing method; (vi) SARAH; (vii) Central American Single Customs Form (FAUCA); (viii) transmission of domestic and international transit; (ix) Auditax audit management (Auditax) (FAD, page 49). There are some exceptions: SARAH, FAUCA, and transit transmission are modern systems.

c. **Auditing**. The databases do not have timely information. The information on returns and invoices is not reliable. There is no information coming from the financial system, insurance companies, credit card administrators, or the Honduran Social Security Institute (FAD, page 31). This problem means that collection procedures are limited. Complete information on past due debt is not available and operational areas have no influence over the enforced collection process.[23]

d. **Information Technology Office (GTI).** This office lacks technical staff for developing and maintaining systems and databases. Only 28 out of a total of 44 employees have an appropriate profile for performing IT functions and no one has a suitable profile for databases. In addition, there is no training and development program for GTI staff.[24]

e. **Technological infrastructure.** The DEI's basic software system is inadequate, is obsolete in some areas, and there is no standardization in database providers. The tax administration's local area network is unstable with shutdowns and inadequate response times. There is not enough space in the databases to store the information that will be generated with the expansion of the taxpayers' tax base. There is a lack of software to supplement the computer center.[25]

1.13 Third, lack of professional development of human resources. The principal causes associated with this problem are:

a. **Human resources policy.** Current policy does not include a specific career path in the taxation area with a competitive salary scale and professional development processes. There is a low ratio between core staff and administrative staff in the staffing structure (one to two), and low compensation on the salary scale,[26] making it difficult to attract and retain the best professionals and managers.[27] There is no merit-based recruitment process, which also undermines the ability to attract and retain suitable staff.

b. **Staff.** Most administrative and technical staff at the DEI do not have the basic profiles or training levels required for managing tax administration properly. Only 34% of staff has a university degree. This situation is exacerbated by the difficulty of recruiting specialized staff for the DEI, due to the lack of

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[23] The current account system does not have online validations for when taxpayers are meeting their tax obligations (e.g., payments) (FAD, page 26). The databases do not have information on the debt subject to administrative proceedings. (FAD, page 27).

[24] There is no mechanism for detecting GTI staff training needs. The results of a survey indicate that 60% of GTI staff did not receive training, 8% did, and the rest were self-taught (Tecnológico de Monterrey-TM, page 46).

[25] There are various databases without the desired integration; they are from different providers (complicating maintenance) and some are quite obsolete. The SIT and vehicles databases are on a 16-year-old Hewlett Packard 9000 model K server running on an ADABAS database from the 1970s. There are databases in Oracle and ADABAS (TM, page 104). The PIX type firewalls were donated in 2001, by the Customs Union Project (TM, page 112).

[26] Between 6,000 and 51,400 lempiras per month in 2012 (or between US$300 and US$2,600 per month).

[27] The established probation period is only three months, entailing a risk of hiring unsuitable staff on a permanent basis, and the position descriptions are obsolete.

transparency in the selection of civil servants in Honduras.[28] In addition, lapses in the professional ethics of staff have been documented. Of a sample of 851 people who were given a lie detector test (polygraph), 30% failed. In 2014, three telephone complaints were recorded per day, on average, related to lack of transparency in the performance of tasks.

c. **Training.** There is no ongoing training program. Candidates hired during recent selection rounds did not have in-depth knowledge of taxation matters. Only 8% of staff had taxation-related training in 2014 (Monterrey Institute of Technology (TM), page 46).

d. **Image.** The DEI's poor corporate image makes recruiting qualified staff difficult, which in turn affects taxpayers' voluntary compliance with their tax obligations. According to a 2011 survey (*Latinobarómetro*), the DEI's level of acceptance is low.

e. **Planning.** Despite significant efforts made by the new administration, there is insufficient capacity for detailed planning of the transition process and startup of the new institution once the hiring is completed. There is no change management tool to facilitate the transition to a new organization. The DEI's current human resources policy is generally incompatible with a modern and highly effective tax administration.

1.14 **Bank strategy with the country and in the sector.** The Bank has collaborated in the strengthening of public finances in Honduras, as well as in the modernization of the public administration. In 2010, the Bank supported a reform to eliminate the zero sales tax rate and expand income tax, among other measures (Law17-2010) (2452/BL-HO). In 2013, the Bank provided technical assistance to design a reform establishing a 3% increase in the ISV rate (Law 278-2013). Legal, institutional, and technological development changes have also been promoted in the area of financial administration (2032/BL-HO). The Bank has supported the strengthening of fiscal policy analysis, monitoring, and evaluation (ATN/OC-14216-HO).

1.15 Through various operations in recent years in the area of customs, the Bank has supported the development of new customs processes through the SARAH computer system, and improvement in the operational infrastructure of border posts.[29] These efforts have provided the basis for improved control of foreign trade transactions.[30] The Bank is also supporting the implementation of a modern risk analysis structure to improve a priori operational activities from the fiscal and parafiscal perspective and to reduce physical inspections of goods and means of transportation.[31] With respect to public administration, support has been provided for restructuring the executive branch (ATN/OC-14590-HO) and improving the efficiency of human resources in government (ATN/FI-14338-RG). This operation

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[28] Honduras was the country with the worst human resources management of the region's 16 countries (12 out of a possible 100 points). Source: IDB (2014), Serving Citizens: A Decade of Civil Service Reforms in Latin America (2004-2013), Washington, D.C.

[29] 1546/SF-HO, 2032/BL-HO, 2467/BL-HO, TC0202017, ATN/OC-13585-HO, ATN/AT-13372-RG, and ATN/MR-13844-RG supporting the implementation of International Transit of Goods.

[30] Honduras currently occupies a prominent position in the World Bank's Logistics Performance Index, holding fifth place in Latin America for best customs performance.

[31] In particular, support was provided for hiring a highly professional group of staff to handle the technical areas of audit and risk assessment (2467/BL-HO).

supplements the Bank's efforts in the sector in Honduras and in particular consolidates support for strengthening tax administration.

1.16 **Lessons learned.** This program is part of the Bank's support for management of tax and customs administration in the region. In particular, the Bank's experience with Ecuador's tax administration reform has been taken into account in this operation. The Bank implemented three programs to modernize the Ecuadorian tax system: (i) reimbursable technical cooperation agreement ATN/SF-3361-EC; (ii) loan agreement 904/SF-EC; and (iii) reimbursable technical cooperation 1062/OC-EC. The Office of Evaluation and Oversight (OVE) evaluated the results of those programs in 2007, rating them as successful.[32] The evaluation showed that the tax ratio in Ecuador increased from 4.9% to 10.9% of GDP over the 1990-2006 period.

1.17 This operation takes into account lessons learned in the modernization of Ecuador's tax administration, which included five principal pillars: (i) increasing the active RTNs/registered RTNs ratio; (ii) increasing the ratio of returns submitted each year/registered RTNs; (iii) increasing the number of invoices issued each year/registered RTNs; (iv) increasing the productivity of large taxpayer audits; and (v) improving the quality of human resources. The operation in Ecuador confirmed how important improving the information on the tax base through better procedures and systems is to a more effective tax administration. In addition, it was demonstrated that the results would not have been the same if human resources had not been strengthened.

1.18 Also considered were lessons learned from Bank support in the area of customs,[33] including good practices with neighboring countries, particularly in the area of technology systems, which can facilitate the startup of those systems. In terms of execution, the lesson was that it was important to invest substantial resources in training for the executing unit, particularly in the area of procurement, and to ensure that it had experts specializing in the principal areas of the operation. The design of the current operation also considered lessons from the Ecuador project (2653/OC-EC) on institutional reform of public management, including: (i) agreeing on as many voluntary terminations as possible, prior to the process of eliminating the institution, so as to minimize potential future labor disputes (the DEI is already in the process of carrying out voluntary terminations); (ii) exhaustive planning of all termination steps through an operations manual for the process; and (iii) the use of an auditing firm to review severance payment processes, so as to introduce an additional control.

1.19 In addition, this operation has been coordinated with the IMF, which has performed diagnostics of the DEI, has provided technical assistance, and is currently monitoring the stand-by agreement with the government.[34]

1.20 **Strategic alignment.** The project is aligned with the sector priorities of the Country Strategy with Honduras for 2015-2018 (document GN-2796-1), through the fiscal consolidation pillar, the main objective of which is to strengthen tax revenue intake. The program will contribute to the financing priority of the Ninth

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[32] Rodríguez, C. (2007). *Modernización de la Administración Tributaria Ecuatoriana: Impacto de la Cooperación Técnica*. Final Report. Discussion paper OVE/TDP-01/07. IDB, pages 47, 67.

[33] *Op. cit.* page 30.

[34] The agreement with the IMF considers strengthening of the Large Taxpayers Unit and the Risk Analysis and Fiscal Intelligence Unit, as well as strengthening of the operational management of customs.

General Increase in the Resources of the Inter-American Development Bank (document AB-2764) (GCI-9) for small and vulnerable countries, by supporting Honduras in strengthening the tax administration. It will also contribute to the regional goal involving the ratio of actual to potential tax revenue; and to the following outputs: (i) public financial systems implemented or renewed (budget, cash flow, accounting, debt, and collection); and (ii) number of cross-border and transnational projects supported (infrastructure, customs, etc.). The project is also in line with the Strategy on Institutions for Growth and Social Welfare (document GN-2587-2), in that it supports tax administration modernization, thereby protecting social and growth objectives.

B. Objectives, components, and cost

1.21 The program's principal objective is to improve tax revenue levels in order to create the fiscal space needed to finance priority spending.[35] The program supports the Government of Honduras's decision to restructure tax and customs administration, to which end the Revenue Administration Service (SAR) is being created to replace the current Revenue Office (DEI). This support will involve: (i) the review and updating of taxation procedures in accordance with the Honduran legal framework; (ii) the modernization of the SAR's systems and technological infrastructure; and (iii) the strengthening of the SAR's human resources.

1.22 The program will benefit: (i) the SAR directly through the development and implementation of a new human resources policy and new staff hired and trained; (ii) the Honduran government (specifically the Ministry of Finance, SEFIN), through increased tax intake that will help to put public finances in order; and (iii) the entire population, by generating resources for investing in priority areas in the country. The program has three components as described below:

1.23 **Component I. Reengineering of tax administration processes (US$2,140,000).** The objective of this component is to make taxation processes more effective for implementing tax administration management in accordance with the Honduran legal framework. To this end, the component will finance the following activities:

a. Revision of the current model and development of a new model for the organization and management of internal revenue (registration, filing, invoicing, audit, collection),[36] including preparation of the related procedural manuals and training of SAR staff in the new procedures.

b. The development of organizational and management rules[37] related to the new procedures (registration, filing, invoicing, audit, collection), which will provide input for the development or purchase of an integrated tax administration system.

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35 Such as social, health, education, and road network development programs.

36 The organization and management model describes in detail all the work processes and flows carried out by the tax administration. It is a function of organization and methods.

37 The organization and management rules are the set of work processes and flows (flow charts) for each of the obligations, functions, and procedures that allow programmers to automate, program, or establish parameters for an off-the-shelf application to carry out these procedures.

c. Strengthening of the Organization and Methods Unit (UOM), including contracting a specialized consulting firm to support and train UOM staff on matters related to internal revenue and planning.

1.24 **Component II. Modernization of the SAR's systems and technological infrastructure (US$9,085,400).** The objective of this component is to enable the production of reliable and timely information for efficiently auditing and collecting from taxpayers. To this end, the following activities will be financed:

a. Implementation of a new integrated tax administration system to replace the existing unintegrated applications. This can be done through hybrid development (a system available on the market that can be adapted to in-house needs with support from the system's proprietors) or by purchasing a highly parameterizable (90%) off-the-shelf package, to allow technology transfer to SAR staff.[38]

b. Updating of the technological infrastructure of basic software, including: (i) standardization of databases, through data scrubbing and migration from the various existing databases to a single database on a modern and easily maintained platform; (ii) increased storage capacity; and (iii) improved security level and access to information at the SAR.

c. An ongoing training program for IT personnel will be implemented, including systems analysis, programming, telecommunications and database management, and IT security and planning.

1.25 **Component III. Strengthening of the SAR's human resources (US$27,604,600).** The objective of this component is to improve the professional quality of the SAR's human resources to effectively carry out the tax administration's institutional mandate. To this end, the component will finance the following activities:

a. Development and implementation of a new human resources policy, including: (i) the taxation career path and the related job descriptions; (ii) labor regulations, salary scale, and performance evaluation procedures; and (iii) promotion. A new code of ethics compatible with the standards of the new organization will also be developed and implemented.

b. The process of selecting and hiring new staff for the SAR, including 700 positions for internal revenue and 800 positions for customs, headed by the government with support from a firm specializing in recruiting, hiring, and identifying talent in the labor market, according to the new job profiles established in the new human resources policy.[39]

[38] The decision to adopt an off-the-shelf package will depend on the following criteria: (i) identification of a system available in the market that meets at least 90% of the required functionality at a price compatible with the budget allocated for this product; and (ii) the system provider's agreement to transfer technology so that, in due time, the system can be self-maintained. If a system that meets these criteria is not identified, a hybrid solution will be adopted.

[39] The SAR's ceiling will be the compensation budget allocated to the current DEI. As staffing levels fall at the DEI, the new entity will have resources to provide more competitive compensation for the new staff, whose selection and hiring will be financed by the Bank.

c. The DEI staff termination[40] and severance process, an eligible expenditure under Bank policies.[41] Loan proceeds will also be used to hire a consulting firm to provide terminated staff with the option of training and general guidance for out-placement. These actions supplement other government efforts to mitigate any social effects.[42]

d. The design and implementation of a change management system and an information campaign geared to public opinion regarding the SAR, seeking to minimize the risks of a reaction to the change among the personnel involved and the general public.

e. The design and implementation of an ongoing training program for all SAR staff.

C. Key results indicators

1.26 Upon completion of program execution, the anticipated impact is to increase tax revenue from 15.3% of GDP in 2013 to 17.1% of GDP in 2019. The principal outcomes are: Procedures: (i) increasing the ratio between the number of active RTNs and the total number of registered RTNs from 12.2% to 36.9%; and (ii) increasing the ratio between the number of comprehensive audits conducted each year and the total number of large taxpayers from 8.5% to 80%. Automation: (i) increasing the level of integration of the data from the various systems supporting tax administration from 33% to 70%;[43] and (ii) increasing the number of tax returns filed electronically from 47% to 90%. Human resources: (i) increasing the ratio between the number of staff with formal education and the total number of SAR staff from 34% to 80%; and (ii) raising the taxpayers' level of perception regarding the corporate image of the tax administration from low to medium (Annex II).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 The total cost of the program is approximately US$40 million, of which the Bank will finance the equivalent of US$27 million, from Ordinary Capital and Fund for Special Operations resources. The Republic of Honduras will provide counterpart funds amounting to US$13 million. The program's financing structure is presented in Table 1.

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40 As part of program preparation, the DEI has agreed to carry out voluntary terminations prior to the DEI's elimination.

41 The expenditure complies with the modernization of policies and practices restricting the use of investment loan funds (GN-2331-5), as well as the guidelines on the eligibility of expenses in investment loans: Proposed amendment (CC-6004-2). The program meets the following requirements: (i) the expenditures are part of tax administration reform in Honduras; and (ii) they contribute to the development of an institutional asset that is necessary for achieving the established development objectives.

42 With Bank support, the DEI is formulating a mitigation strategy to attenuate the potential impact of job termination on the institution's vulnerable staff (based on certain criteria). These measures include the option and priority access to the government's job promotion programs, among others.

43 Only three of the nine systems have integrated data and the goal is for most of them to have it.

Table 1. Total Project Budget (US$)

Categories*	IDB	Local	Total	%
1. Direct costs	25,830,000	13,000,000	38,830,000	97.08
1.1 Reengineering of tax administration processes	2,140,000	0	2,140,000	5.35
1.2 Modernization of the SAR's systems and technological infrastructure	9,085,400	0	9,085,400	22.71
1.3 Strengthening of the SAR's human resources	14,604,600	13,000,000	27,604,600	69.01
2. Project administration	1,170,000	0	1,170,000	2.93
2.1 Technical coordination of execution	180,000	0	180,000	0.45
2.2 Monitoring and evaluation	250,000	0	250,000	0.63
2.3 Specialists	600,000		600,000	1.50
2.4 Audit	140,000	0	140,000	0.35
Total	**27,000,000**	**13,000,000**	**40,000,000**	**100**
%	**67.50**	**32.50**	**100**	

2.2 **Economic rationale.** The Bank's team performed a comparative Economic Evaluation between the economic/financial costs and benefits of the program. The evaluation considered the real increase in tax revenue, as a result of increasing: (i) the ratio of active RTNs to registered RTNs; (ii) the ratio of invoices issued by taxpayers to registered RTNs; and (iii) the ratio of tax returns filed by taxpayers to registered RTNs. The results obtained in a similar operation in Ecuador (1998-2004) and evaluated by OVE in 2007 were used as a basis for calculating the impact of the program.

2.3 Using conservative assumptions, a 2% average annual increase in the tax ratio was estimated.[44] With a discount rate of 12% (and the expected rate of inflation), over a period of five years, the project will generate an internal rate of return (IRR) of 117% by the end of 2019, with a net present value (NPV) of US$124 million. The sensitivity analysis in the worst scenario yielded an IRR of 44% and an NPV of US$40.9 million.

2.4 **Disbursements programming.** Disbursements will be made over a period of five years counted from the signing of the loan contract, according to the disbursement schedule in Table 2.

Table 2. Disbursement Schedule (US$)

Source	Year 1	Year 2	Year 3	Year 4	Year 5	Total	%
IDB	12,818,331	8,234,514	2,933,685	1,809,810	1,203,660	27,000,000	67.50
Local	6,171,789	3,964,766	1,412,515	871,390	579,540	13,000,000	32.50
Total	18,990,120	12,199,280	4,346,200	2,681,200	1,783,200	40,000,000	100
%	47.48	30.50	10.87	6.70	4.46	100	

44 This potential annual average increase in the tax ratio in Honduras is significantly below that seen in the tax administration project in Ecuador: 7.4% over the 1998-2006 period. An increase in the tax ratio of 1.8 points of GDP over five years was estimated for the program. For purposes of the economic evaluation, a more conservative assumption was adopted (an average annual increase of 2% in the tax ratio).

2.5 **Fiduciary context of the country**. With respect to fiduciary management systems, the latest diagnostic (2012) shows important advances toward international good practices and standards, primarily in the modernization of the institutional framework and the integration of the budget, treasury, and government accounting systems. Through operation 2032/BL-HO, the Bank supported the development and implementation of the Integrated Financial Administration System/External Loan Executing Units] (SIAFI/UEPEX) module, while the government has established that its use is mandatory for all externally sourced projects. The government's internal and external control systems are not used in the execution of Bank operations; external audit services are contracted. With respect to the government contracting system, challenges remain for achieving standards that would make it possible for the country system to be used in Bank-financed operations.

B. Environmental and social risks

2.6 According to the criteria of the Bank's Environment and Safeguards Compliance Policy (OP-703), the operation was classified under category "C" in that it is a program for the institutional modernization of tax administration and no risks are anticipated in terms of social and environmental impacts.

C. Fiduciary risks

2.7 Possible delays in procurement and difficulties in project execution due to insufficient capacity at the DEI are classified as medium risks in view of its replacement by the SAR, on fiduciary matters. The risk will be mitigated with the formation of an executing unit exclusively for the project with a highly qualified professional team that includes a technical coordinator, senior specialists in procurement, and specialized consulting firms to support the hiring process. The Bank will provide technical support and update training on its policies.

D. Other project risks

2.8 The operation is classified as medium risk. The main risks are:

a. **Governance**. The risk of a reduction in the intake of tax revenue due to taxpayers' reduced perception of risk of being caught should they fail to meet their tax obligations, as a result of the tax administration transition process, is classified as a medium risk. This risk will be mitigated through an operational transition plan that includes measures to ensure: (i) compliance with the periods established for termination of staff and the hiring of new staff; (ii) continuity in the auditing of large taxpayers and the international trade activity procedures carried out by customs; (iii) expansion of the notaries program; and (iv) implementation of a public information campaign and an institutional change management system during the process.

b. **Development**. There is a medium risk of possible delays in program implementation due to the fact that: (i) the tax administration may not have technical capacity for handling a change of this magnitude. This risk is classified as a medium risk and will be mitigated by contracting specialized consulting firms during the five years of project execution in the principal technical areas; and (ii) the process of terminating staff and hiring new staff may not be concluded due to legal[45] and budgetary problems. This risk will be mitigated through execution of the operational transition plan and arrangements made with SEFIN to ensure the availability of the budgetary resources necessary to execute the reform.

c. **Sustainability**. The inability to maintain the professional level of staff due to the absence of merit-based and transparent criteria, attractive compensation, and technical capacity to hire staff with the required standards is classified as a medium risk. This risk will be mitigated with the implementation of a taxation career path based on open competition, competitive compensation,[46] and performance evaluation procedures. Firms will be used to execute the selection and training of new staff, even after completion of the project.

d. **Implementation**. The risk that the project could be affected by massive labor litigation or popular protests in connection with the termination of DEI staff is classified as a medium risk. This risk will be mitigated through various actions addressing the respective economic policy considerations. These actions include the promotion of voluntary retirements prior to termination, a public information campaign (internal and external),[47] and the formation of a team responsible for executing the severance process, including an ex ante external audit to ensure proper payments pursuant to the law, and a manual of procedures setting out the sequence of the terminations and the timeframes for each related administrative step. Support will also be provided for the design of a strategy of specific mitigation measures for vulnerable personnel.[48]

e. **Monitoring and evaluation**. The risk of delays in the execution of planned activities due to inadequate capacity in the program coordination unit (PCU) for monitoring and preparing accounting reports in accordance with the Bank's standards is classified as a medium risk. This risk will be mitigated through training provided to the PCU team by the Bank in project monitoring and the preparation of accounting reports.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The program's executing agency will be the DEI and, after it is replaced, the SAR. A specific PCU will be created for the project.

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[45] This refers to the possibility of the government's failure to meet the legal deadlines for terminations, which could lead to litigation that delays the tax administration modernization process.

[46] For the sustainability of the level of compensation in the tax administration over the next few years, consideration was given to the fact that the budget allocated for staff is not being reduced while the total number of staff is, since there is an imbalance between technical and administrative staff. It will therefore be possible to reach a desirable level of compensation to be offered to all staff, compatible with the public sector.

[47] A mapping of the actors is expected to be done to identify pertinent strategic allies in the implementation of tax administration reform and the related communication campaign.

[48] The sector strategic plan of the Honduran government's Development and Social Inclusion Council identifies the following population groups as vulnerable: poor women, women heads of household with children in their care; indigenous and Afro-Honduran communities, the elderly, and people with disabilities.

3.2 The PCU structure will be comprised of the following job profiles at a minimum: (i) a general coordinator; (ii) a monitoring and evaluation specialist; (iii) a financial specialist; (iv) two procurement specialists; and (v) the required technical staff.

3.3 The PCU will be responsible for: (i) planning the execution of activities; (ii) preparing and implementing the annual work plan (AWP) and updating the procurement plan; (iii) supervising execution and submitting reports; (iv) conducting goods bidding and procurement, works bidding and contracting, and services selection and contracting; (v) submitting disbursement requests to the Bank; (vi) preparing financial statements; and (vii) submitting the program evaluation. The program expects to rely on technical cooperation operation HO-T1220, now being prepared, to support its execution.[49]

3.4 **The special contractual conditions precedent to the first disbursement of loan proceeds are: (i) approval, to the Bank's satisfaction, of the executive decrees providing, respectively, for the elimination of the DEI and the creation of the SAR to replace the current DEI; (ii) the entry into force of the subsidiary agreement between the borrower, represented by SEFIN, and the DEI (the SAR upon approval of the aforementioned decrees) for the transfer of project resources and execution obligations; (iii) creation of the PCU; (iv) implementation of the SIAFI/UEPEX; and (v) confirmation by the borrower, via legal opinion, of the validity of its obligation with respect to the local contribution.**

3.5 The special conditions for execution are as follows: (i) the creation of a special separate account for managing the local counterpart, in which funds to reimburse retroactive financing will be deposited, which will be used exclusively to finance such local counterpart; and (ii) the financing of the job terminations provided for in Component III, subject to the Bank receiving evidence that such terminations comply with: (a) the criteria and requirements established in the program; (b) legal and constitutional provisions in effect in the country; and (c) relevant labor-related legal and administrative procedures and standards as applicable.[50]

3.6 **Procurement of works, goods, and nonconsulting services.** Contracts for works, goods, and nonconsulting services[51] under the project and subject to international competitive bidding (ICB) will be executed using the standard bidding documents (SBDs) issued by the Bank. Contracts subject to national competitive bidding (NCB) will be executed using national bidding documents agreed upon with the Bank and published on the website of the Oficina Normativa de Contratación y Adquisiciones del Estado [Honduran Government Procurement Office] (ONCAE).

3.7 **Procurement, selection, and contracting of consultants.** Consulting services contracts will be executed using the standard request for proposals (RFP) issued

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[49] The technical cooperation operation is now going through the process of approval with funds from the Special Program for Institutional Development. In particular, the technical cooperation operation would be supporting the process of transferring tax administration from the DEI to the new SAR and strengthening the SAR's human resources.

[50] To this end, the Bank will require two legal opinions, one from the borrower or executing agency and the other from the Commission for Centralized and Decentralized Public Administration Reform.

[51] Policies for the procurement of goods and services financed by the IDB (GN-2349-9), paragraph 1.1: Nonconsulting services are treated as goods.

by or agreed upon with the Bank.[52] Consulting firms will be selected and contracted in accordance with Bank policies. At the discretion of the executing agency, individual consultants may be contracted through local or international announcements in order to prepare a shortlist of qualified individuals.

3.8 **Direct contracting.** The operation provides for the possibility of direct contracting of the Inter-American Center of Tax Administrations (CIAT) for up US$2 million, to support the establishment of operating rules, development of work flows, parameterization, and rules for the future IT system that will govern SAR operations. The CIAT is a nonprofit international public agency that provides specialized technical assistance for updating and modernizing tax administrations on four continents. It therefore has exceptional experience for providing services, as established in paragraph 3.10(d) of document GN-2350-9. The CIAT is the only technical assistance firm that has participated in a tax administration reform process of this kind in the region (Ecuador 1998-2004). The consultants contracted to assist the executing agency may be contracted directly, based on clause 5.4(a) of document GN-2350-9 (see Annex III).

3.9 **Retroactive financing and recognition of eligible expenses.** The Bank may retroactively finance and charge against the loan proceeds up to US$5.4 million (20% of the proposed loan amount) for eligible expenses incurred by the borrower prior to the loan approval date and included in the expenditure categories defined in Annex III, provided they have complied with requirements substantially analogous to those established in the loan contract. Said expenditures must have been incurred as of 18 February 2015 (project profile approval date) but in no case more than 18 months prior to the loan approval date. The amount the Bank reimburses under this heading will be credited to a special account to be set up by the borrower that will be used exclusively to ensure the availability of counterpart funds during project execution. In addition, the Bank may recognize and charge against the local contribution up to US$6.5 million (50% of the estimated local contribution) for severance payments to staff.

3.10 **Procurement Plan Execution System (SEPA), AWP, and procurement plan.** The procurement plan will be managed through the SEPA. The borrower will submit that plan to the Bank together with a draft AWP for the first 18 months, running from the loan contract signature date.

3.11 **Audited financial statements (AFSs).** The borrower will submit AFSs to the Bank each year within 120 days of the close of each fiscal year.

3.12 **Disbursement plan.** The borrower will submit for the Bank's consideration a financial resources disbursement plan for each six-month period of execution, indicating the need for advances of funds for the period.

B. Summary of arrangements for the monitoring of results

3.13 **Monitoring** will be based on: (i) the Results Matrix; (ii) the programming of activities; (iii) the breakdown of physical and financial execution of outputs with the semiannual progress reports; (iv) procedures of the methodology for supporting project preparation and supervision; and (v) the descriptions of procurement and contracting appearing in the procurement plan.

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[52] Policies for the selection and contracting of consultants financed by the IDB (GN-2350-9).

3.14 **Evaluation**. It will be based on the measurement of results, which will use the self-assessment and economic evaluation methodologies (see Monitoring and Evaluation Plan). The program will be evaluated according to the annual targets and indicators for the outputs and outcomes that make up the program's results framework. At the output level, a baseline, a target, and their respective annual stages are defined (Annex II).

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	**Aligned**		
Lending Program	**-Lending to small and vulnerable countries**		
Regional Development Goals	**-Ratio of actual to potential tax revenue**		
Bank Output Contribution (as defined in Results Framework of IDB-9)	**-Public financial systems implemented or upgraded (budget, treasury, accounting, debt, and revenues) -Number of cross border and transnational projects supported (infrastructure and customs, etc.)**		
2. Country Strategy Development Objectives	**Aligned**		
Country Strategy Results Matrix	**GN-2796-1**	**To strengthen tax revenue intake.**	
Country Program Results Matrix	**GN-2805**	**The intervention is included in the 2015 Operational Program.**	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	**Evaluable**	**Weight**	**Maximum Score**
	8.7		**10**
3. Evidence-based Assessment & Solution	**9.4**	**33.33%**	**10**
3.1 Program Diagnosis	**2.4**		
3.2 Proposed Interventions or Solutions	**4.0**		
3.3 Results Matrix Quality	**3.0**		
4. Ex ante Economic Analysis	**10.0**	**33.33%**	**10**
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**4.0**		
4.2 Identified and Quantified Benefits	**1.5**		
4.3 Identified and Quantified Costs	**1.5**		
4.4 Reasonable Assumptions	**1.5**		
4.5 Sensitivity Analysis	**1.5**		
5. Monitoring and Evaluation	**6.6**	**33.33%**	**10**
5.1 Monitoring Mechanisms	**2.5**		
5.2 Evaluation Plan	**4.1**		
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	**Medium**		
Identified risks have been rated for magnitude and likelihood	**Yes**		
Mitigation measures have been identified for major risks	**Yes**		
Mitigation measures have indicators for tracking their implementation			
Environmental & social risk classification	**C**		
IV. IDB´s Role - Additionality			
The project relies on the use of country systems			
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, External control. Procurement: Information System.**	
Non-Fiduciary			
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**Using resources from loans HO-L1015 and HO-L1055, the Bank will provide, to those involved in the implementation of the project, training on management, monitoring and evaluation, and procurement processes, using Bank policies.**	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

The overall objective of the program is to improve tax collection in Honduras by supporting the restructuration of the Taxation National Agency. The program will be organized and implemented around three major components: (i) reengineering processes of the Tax Administration (TA); (ii) modernization of systems and technological infrastructure of the Revenue Management Service (SAR); and (iii) Strengthening of human talent at SAR.

The diagnosis is supported by extensive empirical evidence, and establishes that the main problem are the insufficient receipts due to the ineffectiveness of the tax processes (registration, declaration, invoicing, auditing and collection), the low quality of the information –which is not reliable to control and collect taxes-, and to the low level of professionalization of the civil servants in charge of Tax Administration. Even with this comprehensive diagnostic, it is not possible to infer the relative importance of the different causal factors, the main deficiencies identified, or their importance to other possible factors.

The results matrix has vertical logic. The expected impact of the program is an increase of the revenue collection as a percentage of GDP. This increase is a result of a set of results related to billing, registration, data integration and further training of officials, among others. All sets of indicators, outcomes and outputs, are complete.

The project has an ex ante financial analysis. The calculation has been made in real term Lempiras and converted into Dollars. The period considered for financial analysis coincides with the period of the project, which exceeds the period of the International Monetary Fund Program. The NPV is positive and IRR is high.

The monitoring and evaluation plan has a multiyear execution plan and intends to conduct an ex post cost-benefit analysis to assess the results achieved.

RESULTS MATRIX

Project objective:	The principal objective of the program is to improve tax revenue levels in order to create the fiscal space needed to finance priority expenditures. The program supports the Honduran government's decision to restructure tax and customs administration, for which purpose it is creating the SAR to replace the current DEI. This support will be provided through: (i) the revision and updating of taxation processes in accordance with the Honduran legal framework; (ii) modernization of the SAR's technological infrastructure and systems; and (iii) strengthening of the SAR's human resources.

EXPECTED IMPACT

Indicators	Unit of measurement	Baseline		Targets					Source/Verification method	Observations
		Value	Year	2015	2016	2017	2018	2019		
1.1 Increase the tax ratio of tax administration in Honduras										
Tax intake/GDP	%	15.3	2013	16.1	16.1	16.4	16.7	17.1	Article IV 2019–IMF.	17.1%: agreed target under stand-by agreement with the IMF. **Baseline:** Tax intake = LP$57,777,777 GDP = LP$377,630,000 (1US$ = LP$21.3).

EXPECTED OUTCOMES

Indicators	Unit of measurement	Baseline		Goals					Source/Verification method	Observations/Baseline
		Value	Year	2015	2016	2017	2018	2019		
1.1 Increase the ratio between the number of active RTNs and the total number of registered RTNs (tax base)										
Number of active RTNs/Total number of registered RTNs.	%	12.2	2014	11.9	14.14	21.45	30.51	36.95	Annual management report by the SAR's registry office.	Active RTNs = 107,454 Total RTNs = 893,904.
1.2 Increase the ratio between the number of invoices issued by taxpayers and registered RTNs										
Number of invoices issued/Number of registered RTNs.	%	1.9	2014	1.9	3.0	4.8	7.7	12.3	Annual management report by the SAR's sales tax management office.	Invoices = 16,831 Registered RTNs = 893,904.
1.3 Increase the ratio between the number of tax returns filed by taxpayers and registered RTNs										
Number of tax returns filed /Number of registered RTNs.	%	6.99	2014	6.99	8.31	13.78	17.94	21.72	Annual management report by the SAR's individual/legal entity management office.	Returns = 62,523 Registered RTNs = 893,904.
1.4 Increase the ratio between the number of comprehensive audits conducted per year and the total number of large taxpayers										
Total comprehensive audits/Total number of large taxpayers (LTs).	%	8.5	2013	10	20	40	60	80	Annual management report by the SAR's Audit Office.	Audits = 51 LTs = 602 Comprehensive audits include internal revenue and customs.

1.5 Increase the level of integration of data in the various systems supporting tax administration										
Number of systems with integrated data/Total number of existing systems.	%	33	2014	22	22	50	70	70	Annual management report by the SAR's Information Technology Office (GTI).	Number of systems with integrated data = 3 Total existing systems = 9[1]
1.6 Reduction in the level of errors in loading tax returns in the respective systems										
Number of tax returns[2] with errors/Total number of returns.	%	40	2014	40	30	20	10	1	Annual management report by the SAR's GTI.	Number of tax returns with errors = 2,500 Total tax returns = 62,523.
1.7 Increase the percentage of tax returns filed electronically										
Number of electronic returns[3]/Total tax returns.	%	47	2014	47	50	70	80	90	Idem.	Number of electronic returns = 29,385 Total returns = 62,523.
1.8 Increase the ratio between the number of staff with formal education and the total number of staff at the SAR										
Number of staff with formal education/Total staff.	%	34	2014	34	80			80	Annual management report by the SAR's Human Resources Office.	Number of staff with formal education = 816 Total staff = 2,400.
1.9 Improve taxpayers' perception regarding the corporate image of the tax administration										
Level of perception.	Level	Low	2011	Low	Low	Medium	Medium	Medium	Public opinion survey conducted by the SAR's Public Relations Office.	A survey was conducted in 2011 by Latinobarómetro. Perception among those surveyed regarding the DEI is low.
1.10 Increase the ratio between the number of staff receiving annual training and the total number of staff										
Number of staff receiving training/Total staff.	%	8	2013	8	8	80	80	80	Annual management report by the SAR's Human Resources Office.	Number of staff trained = 192 Total staff = 2,400.

[1] Existing systems: (i) Taxation System (eTAX); (ii) Integrated Tax System (SIT); (iii) File Control System (CONEX); (iv) Vehicle Tax Collection System, Ifénix Returns Loader; (v) Traditional tax filing method; (vi) Automated Customs Revenue System of Honduras (SARAH), (vii) Central American Single Customs Form (FAUCA), (viii) Transmission of internal and international transits; and (ix) audit management (Auditax). Of these, only eTAX, SARAH, and Auditax have partially integrated data.

[2] Income tax of Individuals and legal entities.

[3] Income tax of Individuals and legal entities.

OUTPUTS

Indicators	Unit	Baseline		Goals					Source/Verification method	Observations/Output
		Value	Year	2015	2016	2017	2018	2019		
COMPONENT I: Reengineering of tax administration processes										
1.1 Manuals of procedures (registration, filing, invoicing, audit, and collection) prepared.	Manuals	0	2014	11				11	Manuals of procedures by the SAR's organization and methods unit (UOM).	Review and development of new business model for internal revenue.
1.2 Detailed description of organization and management rules for the new procedures prepared.	Flow charts	0	2014	11				11	Flow charts detailing the business rules by the SAR's information technology office (GTI).	Development of the business rules for the new procedures.
1.3 UOM staff trained.	Staff	0	2014	6				6	Semiannual management report by UOM.	Strengthening of the UOM.
COMPONENT II: Modernization of the SAR's systems and technological infrastructure										
2.1 New integrated system of internal revenue tax administration installed.	System	0	2014		Develop./ purchase	Tests	1 final installa-tion	1	Annual report by the SAR's GTI.	Installation of a new integrated tax administration system.
2.2 DEI's technological infrastructure of basic software updated.	Infrastruc-ture	0	2014	Data base		1 basic soft-ware		1	Annual management report by the SAR's GTI.	Updating of technological infrastructure of basic software. The DEI's technological infrastructure included internal revenue and customs.
2.3 IT staff trained.	Individuals	0	2014	30 Program-ming-	40 systems and telecom-munica-tions analysis	10 data bases		80	Annual management report of the SAR's GTI.	Implementation of a training program for IT staff.
COMPONENT III: Strengthening of the SAR's human resources										
3.1 Human resources policy implemented.	Policy	0	2014	Devel-opment	1 imple-mentation			1	Publication of new policy on the SAR's website.	Development and implementation of a new human resources policy.

OUTPUTS

Indicators	Unit	Baseline		Goals					Source/Verification method	Observations/Output
		Value	Year	2015	2016	2017	2018	2019		
3.2 New SAR staff hired.	Staff	0	2014		700 internal revenue	800 cus-toms		1,500	Annual management report by the SAR's Human Resources Office.	New SAR staff selection and hiring process.
3.3 DEI staff terminated and paid severance.	Staff	0	2014		1,500 internal revenue	710 cus-toms		2,210	Idem.	DEI staff termination and severance process.
3.4 Change management system installed.	System	0	2014	1				1	Idem.	Installation of a change management system.
3.5 Information campaign for public opinion implemented.	Campaign	0	2014	1				1	Idem.	Implementation of an information campaign for public opinion.
3.6 Ongoing training program for all SAR staff implemented.	Staff trained	0	2014		500 internal revenue staff	600 customs staff	400 other staff	1,500 staff	Idem.	Implementation of an ongoing training program for all SAR staff.

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country: Honduras

Project number: HO-L1108

Name: Tax Administration Institutional and Operational Strengthening

Executing Agency: Dirección Ejecutiva de Ingresos [Revenue Office] (DEI) and, upon approval of the executive decrees, the Servicio de Administración de Rentas [Revenue Administration Service] (SAR).

Prepared by: Nalda Morales (FMP/CHO) and Juan Carlos Martell (FMP/CHO).

I. EXECUTIVE SUMMARY

1.1 There are risk factors related to the Honduran public sector's institutional capacity to execute projects to be financed under the Bank's current strategy with the country. To mitigate this risk, the Bank continues to carry out a variety of actions to provide technical support and strengthen the public sector. With respect to fiduciary management systems, the latest diagnostic (2012) in Honduras shows significant progress toward international good practices and standards, primarily in the modernization of the institutional framework and the integration of the budget, treasury, and government accounting systems. The government's internal control system is not used in executing the Bank's portfolio; external audit services are used for Bank-financed operations. In 2014, a Strategic Partnership was signed with the Auditor General's Office that will make it possible to move gradually toward using this entity to develop external control services for Bank-financed operations in the country. With regard to the public contracting system, the country still faces challenges in meeting the standards that would allow the Bank to use the country system in the operations it finances.

A. Fiduciary context of the executing agency

1.2 The executing agency for the operation will initially be the DEI, and then the SAR upon approval of the executive decrees. Currently the DEI is executing loan 2467/BL-HO through a project executing unit (PEU) and uses the SIAFI, with its budget, accounting, and treasury subsystems and a UEPEX module, through SEFIN's projects administration unit for financial management. With respect to procurement, the PEU has the experience necessary for: (i) carrying out procurement processes in accordance with Bank policies; (ii) publishing Bank-financed procurement processes in HONDUCOMPRAS, the official government site for publicizing government purchasing and contracting opportunities; and (iii) utilizing standard national competitive bidding and shopping documents for the procurement of goods and works, as agreed by the Bank and the Honduran Government Procurement Office (ONCAE).

B. Fiduciary risk evaluation and mitigation actions

1.3 Based on the available information, the fiduciary team determined that the project risk associated with financial and procurement management is medium. This conclusion basically relates to the operational capacity and knowledge of Bank policies of the executing agency that will perform fiduciary management through a program coordination unit (PCU).

1.4 The principal fiduciary risks and their respective mitigating measures are identified in the Risks Matrix. In particular, with respect to financial and accounting management, the identified risks will be mitigated through implementation of the SIAFI/UEPEX in the executing agency's PCU as well as all the national controls stemming from its use. They will also be mitigated through the contracting of annual external audit services.

1.5 With respect to procurement, the identified risks related to DEI (and then SAR) capacity to carry out procurement according to Bank procedures will be mitigated through the creation of an executing unit specifically for this project, to be trained by the Bank on procurement policies, and by retaining procurement specialists throughout execution. In addition, the planning area will be strengthened with the implementation of a procurement plan execution system, as agreed with the Bank.

C. Considerations for the special provisions of contracts

1.6 Highlighted below are the agreements and requirements that should be considered in the special clauses of the loan contract:

a. **Conditions precedent to the first disbursement**. Conditions precedent to the first disbursement will be: (i) approval, to the Bank's satisfaction, of the executive decrees providing, respectively, for the elimination of the DEI and the creation of the SAR to replace the current DEI; (ii) the entry into force of the subsidiary agreement between the borrower, represented by SEFIN, and the DEI (the SAR upon approval of the aforementioned decrees) for the transfer of project resources and execution obligations; (iii) creation of the PEU and appointment of the project management team consisting of suitable staff with the no objection of the Bank to the terms of reference and the contracting process; (iv) implementation of the SIAFI/UEPEX; and (v) confirmation by the borrower, via legal opinion, of the validity of its obligation with respect to the local contribution.

b. **Special conditions for execution.** (i) creation of a special separate account for managing the local counterpart, in which funds to reimburse retroactive financing will be deposited, which will be used exclusively to finance such local counterpart; and (ii) financing of the layoffs provided for in Component III, subject to compliance with: (a) the criteria and requirements established in the program; (b) legal and constitutional provisions in effect in the country; and (c) pertinent legal and administrative procedures and standards as applicable.[1]

[1] To this end, the Bank will require two legal opinions, one from the borrower or executing agency and the other from the Commission for Centralized and Decentralized Public Administration Reform.

c. **Exchange rate agreed upon with the executing agency/borrower for accounting purposes**. For purposes of the provisions of Article 3.06(b) of the loan contract's General Conditions, the applicable exchange rate will be that indicated in paragraph (b)(ii) of that article. In this case, the applicable exchange rate will be that which is in effect on the date that the beneficiary, the executing agency, or any other individual or legal entity authorized to incur expenditures makes the respective payments to the contractor or provider.

d. **Financial statements and other audited reports**. External audit services will be contracted for the ex ante review of the supporting documentation for disbursements associated with staff severance payments. Supporting documentation for the use of Bank funds for this purpose will be backed by the external audit report, using the procedures agreed upon for verifying records and vouchers related to expenses incurred or payments made. Those expenditures that according to the aforementioned report are not considered eligible for the program must be refunded using local counterpart funds. With the proper analysis, the Bank may consider using the services of the Auditor General's Office of Honduras to perform the planned audits in whole or in part.

D. Agreements and requirements for procurement execution

1.7 Fiduciary agreements and requirements for procurement establish the provisions applicable for the execution of all procurement planned in the project.

E. Procurement execution

1.8 The DEI (and then the SAR), through the PCU, will be responsible for carrying out the processes of selection, bidding, contracting, supervision, and acceptance of project procurement, in accordance with documents GN-2349-9 and GN-2350-9 and the provisions of the operation's procurement plan, which will detail: (i) the contracts for works, goods, and consulting services required to carry out the project; (ii) the methods proposed for the procurement of goods and the selection of consultants; and (iii) the procedures used by the Bank for examining each of the procurement processes. One part of Component III considers financing the termination of DEI staff, to which the aforementioned procurement policies are not applicable. For procurement planning, the executing agency must update the procurement plan each year, or according to the project's needs, using the procurement plan execution and monitoring system identified by the Bank. Any change in the procurement plan must be submitted to the Bank for approval. The PCU will agree with the Bank on a procurement plan for the first 18 months of execution.

1.9 **Procurement of works, goods, and nonconsulting services**. Contracts of this type[2] generated under the project and subject to international competitive bidding (ICB) will be executed using the standard bidding documents (SBDs) issued by the Bank. Bidding subject to national competitive bidding (NCB) will be executed

[2] Policies for the procurement of works and goods financed by the IDB (document GN-2349-9) paragraph 1.1: Nonconsulting services are treated as goods.

using national bidding documents agreed upon with the Bank and published on the website of the ONCAE.

1.10 **Selection and contracting of consultants**. Processes of this type generated under the project will be executed using the standard request for proposals (RFP) issued by or agreed upon with the Bank.[3]

a. **Selection of consulting firms**. Consulting firms will be selected and contracted in accordance with the Bank's policies.

b. **Selection of individual consultants**. At the discretion of the executing agency, individual consultants may be contracted by means of local or international announcements used to prepare a shortlist of qualified individuals. Consultants contracted to assist the executing agency during the operation's execution period may be contracted directly subject to a positive evaluation of their performance, based on clause 5.4(a) of document GN-2350-9, considering continuity of their services provided under operations 2032/BL-HO and 2467/BL-HO executed by the DEI.

1.11 **Retroactive financing and recognition of eligible expenses**. The Bank may retroactively finance and charge against loan proceeds up to US$5.4 million (20% of the proposed loan amount) for eligible expenses incurred by the borrower prior to the loan approval date—provided such expenses complied with requirements substantially analogous to those established in the loan contract—for consulting services for the review of the organization and management model, development of the organization and management rules, database administration, development of the new human resources policy, management coaching for the transition process, the process for selecting and hiring new staff, the design and implementation of an ongoing training program, development and implementation of a public opinion information campaign, and program management. Such expenses must have been incurred as of 18 February 2015 (project profile approval date) but in no case may they include expenses incurred more than 18 months prior to the loan approval date. The amount the Bank reimburses for this purpose will be credited to a special account to be set up by the borrower that will be exclusively used to ensure the availability of counterpart funds during project execution and once execution begins.

1.12 In addition, the Bank may recognize and charge against the local counterpart up to the amount of US$6.5 million (50% of the estimated amount of the local counterpart) for payment of severance to staff.

a. **Advance purchases**. Given the characteristics of this operation and the schedule for completing the actions planned for the transition and termination of current staff, the operation provides for retroactive financing of key activities, of which the following are the most important: (i) the contracting of a firm with international experience to conduct the staff selection process, for up to the amount of US$284,000; due to the type of service to be provided, that selection process may be based on the consultants' qualifications as established in paragraph 3.7 of document GN-2350-9; (ii) the possible direct

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[3] Policies for the selection and contracting of consultants financed by the IDB (document GN-2350-9).

contracting of the CIAT for up to US$2 million, to support the establishment of the operating rules, the development of work flows, parameterization, and rules for the future IT system that will govern SAR operations. The CIAT is an international nonprofit public agency that provides specialized technical assistance for tax administration updating and modernization on four continents. It has experience of exceptional worth for the assignment, as established in paragraph 3.10(d) of document GN-2350-9. In addition, the CIAT is the only technical assistance firm that has participated in a tax administration reform process of this kind in the region (Ecuador 1998-2004); and (iii) the contracting of individual consultants for the review of models, support for design activities and preparation of terms of reference, operational support, and other activities. The procedures for contracting these professionals will be governed by section V of document GN-2350-9. The Bank will review in advance the terms of reference and contracts negotiated in all cases.

F. Threshold amounts (US$ in thousands)

1.13 Thresholds determining the use of ICB and the preparation of the shortlist of international consultants will be made available to the executing agency. Below said thresholds, the selection method will be determined according to the complexity and characteristics of the procurement, which should be reflected in the procurement plan approved by the Bank.

Table 1. Major Procurement Processes

Activity	Type of bidding	Estimated date	Estimated amount (US$000)
Works			
Remodeling of central building	ICB		2,000
Consulting firms[4]			
CIAT, consulting assignment for developing operating rules	SSS		2,000
Development of the SAR's IT system	QCBS		5,000
Goods			
Procurement of SAR computer equipment	ICB		3,420
Procurement of computer hardware	ICB		1,500

[4] In consulting services, this means the formation of a shortlist comprised of firms of various nationalities (document GN-2350-9 paragraph 2.6).

G. Major procurement processes

1.14 The DEI will be responsible for preparing the procurement plan.[5] The Bank's procurement specialist will provide assistance in accordance with the Bank's procurement policies. Major procurement processes planned for this operation are summarized in the project's procurement plan.

H. Supervision of procurement

1.15 According to the analysis of fiduciary risk in procurement, the supervision method will be a combination of ex post and ex ante review as established in the procurement plan.

I. Special provisions

1.16 **Measures for reducing the probability of corruption**. According to the provisions of documents GN-2349-9 and GN-2350-9.

1.17 **Other special procedures**. At its discretion, the Bank may change the procurement supervision arrangements. The Bank recommends drawing up an operational guide to procurement indicating work flows, deadlines, and those responsible for the different types of procurement envisaged.

J. Records and files

1.18 The PCU will be responsible for maintaining the files and original supporting documentation on procurement processes performed.

II. FINANCIAL MANAGEMENT AGREEMENTS AND REQUIREMENTS

A. Programming and budget

2.1 For certain purposes, legislative approval is not required to reallocate and expand budgets for externally sourced projects. Instead, agreements and amendments may be approved by SEFIN or the President of the Republic, subject to the budgetary availability. The Bank's financial parameters for the country allow the financing of an entire project or program.

2.2 **Accounting and information systems**. The SIAFI/UEPEX module is used for financial and accounting reports on Bank-financed project. The project's financial and accounting transactions will be based on the practices of this country system. Accounting records will be kept on a cash basis.

2.3 **Disbursements and cash flow**. The executing agency will open a special account in the name of the project at the Central Bank of Honduras (BCH) for the disbursement of funds. The maximum amount of each advance of funds will be set by the Bank based on the cash flow analysis submitted by the executing agency.

[5] Documents GN-2349-9 (paragraph 1.16) and GN-2350-9 (paragraph 1.23): the borrower will prepare and, before loan negotiations, furnish to the Bank for its approval, a Procurement Plan acceptable to the Bank for an initial period of at least 18 months (Guide for preparation and implementation of the procurement plan).

2.4 **Internal control and internal audit**. In this specific case, the executing agency will develop its fiduciary functions with the support of the PCU established for the purpose, within the framework of operations financed by the Bank in this sector.

2.5 **External control and reports**. It is anticipated that to the extent that progress is made in implementing the strategic partnership, consideration could be given to the partial or full use of the services of the Auditor General's Office in this operation.

2.6 Based on the above, the following financial agreements and arrangements have been determined:

a. External financial audits of the project will be performed each year.

b. For the Bank's part, the rules to be used in this operation are the Financial Management Policy for IDB-financed Projects (OP-273) and the Financial Management Operational Guidelines for IDB-financed Projects (OP-274), according to the versions in effect at the time the operation is approved.

c. The total estimated cost of the audit services is US$140,000, to be financed from loan proceeds. The firm of independent auditors will be selected and contracted on the basis of document AF-200.

2.7 **Financial supervision plan**. The Bank will supervise the financial management of the project, monitoring the actions to be taken by the executing agency or the borrower to address any observations and findings identified in the course of the external audits. In addition, the Bank will conduct visits and hold meetings to monitor the implementation of recommendations from the external audits and the monitoring of fiduciary risks. Supervision will be carried out by the Bank's financial management specialist assigned to the operation, with support from external audit services and consultants, in coordination with the Team Leader, the other members of the project team, the authorities of the Bank's Country Office in Honduras, and VPC/FMP. Disbursements will be reviewed on an ex post basis as part of the external control tasks of the entity contracted, the external auditing firm, or the Auditor General's Office.

2.8 **Execution mechanism**. Project execution will be the responsibility of the DEI and then, upon approval of the executive decrees, of the SAR. There will be a specific PCU for the project, which will use the SIAFI/UEPEX for financial execution and will consist of at least: (i) a general coordinator; (ii) a monitoring and evaluation specialist; (iii) a financial specialist; (iv) an accountant; and (v) two procurement specialists, who must meet requirements and qualifications acceptable to the Bank. This executing unit must coordinate with the administrative and technical areas of the DEI and then the SAR that are responsible for the different components. Details on the execution mechanism must be shown in the project's Operations Manual.

2.9 **Other financial management agreements and requirements**. The fiduciary risks identified during project development will be monitored, strengthening actions necessary to provide reasonable assurance of the proper and efficient use of resources will be proposed, and changes will be made to the fiduciary arrangements as necessary to ensure this objective.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/15

Honduras. Loan ____/BL-HO to the Republic of Honduras
Tax Administration Institutional and
Operational Strengthening

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting a financing to cooperate in the execution of the institutional and operational strengthening of the tax administration. Such financing will be for the amount of up to US$16,200,000 from the resources of the Single Currency Facility of the Bank's Ordinary Capital, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ September 2015)

LEG/SGO/CID/IDBDOCS#39841859
HO-L1108

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/15

Honduras. Loan ____/BL-HO to the Republic of Honduras
Tax Administration Institutional and
Operational Strengthening

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting a financing to cooperate in the execution of the institutional and operational strengthening of the tax administration. Such financing will be for the amount of up to US$10,800.000 from the resources of the Bank's Fund for Special Operations, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ September 2015)

LEG/SGO/ CID/IDBDOCS#39841961
HO-L1108