

**MILLENNIUM CHALLENGE CORPORATION
CONGRESSIONAL NOTIFICATION**

June 17, 2005

PROGRAM:	Eligible Countries
APPROPRIATIONS CATEGORY:	FY 2004 Program Funds
OBLIGATION AMOUNT:	\$215,000,000

In accordance with section 610 (b)(1) of the Millennium Challenge Act of 2003 (the “Act,” Pub. L. 108-199, Division D), this is to advise that the Millennium Challenge Corporation (MCC) has entered into a Compact with the Government of the Republic of Honduras pursuant to Section 609 of the Act. The United States Government, acting through the MCC, and the Government of the Republic of Honduras executed the Compact documents on June 13, 2005. The provisions of the Compact will enter into force pursuant to Section 1.3 of the Compact, including satisfaction of certain conditions set forth in Section 4.1.

A detailed summary of the Compact follows along with a copy of the text of the Compact.

**Summary of the Millennium Challenge Compact
with the Republic of Honduras**

I. Introduction

Following the devastation of Hurricane Mitch in 1998 and the subsequent reconstruction effort, Honduras now enjoys a window of opportunity to capitalize on the democratic reforms begun in the 1980s, the economic liberalization of the 1990s, and increasing regional integration, trade liberalization and the promise of The Dominican Republic – Central America – United States Free Trade Agreement (“*DR-CAFTA*”). Honduras has begun to seize this opportunity and use its strategic location to generate economic growth, particularly in light manufacturing, non-traditional agriculture and tourism. However, as laid out in the country’s Poverty Reduction Strategy, Honduras needs to ensure that growth extends to the rural population by enhancing agricultural development and linking its large rural population to markets.

After considering feedback from the consultative process and the efforts of other donors, the GOH and MCC mutually agreed that the MCC Program will focus on alleviating two key impediments to economic growth: low agricultural productivity and high transportation costs. To address these two impediments, the Program will work to achieve the following two (“*Objectives*”):

- Increase the productivity and business skills of farmers who operate small- and medium-size farms and their employees (“*Agricultural Objective*”), and
- Reduce transportation costs between targeted production centers and national, regional and global markets (“*Transportation Objective*”).

There are strong synergies between the two Objectives. Reducing the cost of transporting inputs to the farm and crops to market will increase the impact of improvements in farmer productivity and business skills. The investment of \$215 million and achievement of these two Objectives will increase annual income by an estimated \$69 million by the end of the Compact. To accomplish these Objectives, the Program will undertake a **Rural Development Project** and a **Transportation Project**, as outlined below.

II. Program Activities, Costs and Performance

Program Costs (\$U.S. millions)		
Rural Development Project		72.2
1. Farmer Training and Development	27.4	
2. Farmer Access to Credit	13.8	
3. Farm to Market Roads	21.5	
4. Agricultural Public Goods Grant Facility	8.0	
5. Rural Development Project Management	1.5	
Transportation Project		125.7
1. Highway CA-5	96.4	
2. Secondary Roads	21.3	
3. Vehicle Weight Control	4.7	
4. Transportation Project Management	3.3	
Program Management and Oversight		17.1
1. Program Management Unit (PMU)	9.3	
2. Auditing	2.8	
3. Monitoring and Evaluation (in addition to PMU)	5.0	
TOTAL		215

A. *Rural Development Project (\$72.2 million over 5 years)*

Honduras enjoys a comparative advantage in horticulture given its rich growing conditions, year-long growing season, and close proximity to the U.S. market. Despite this advantage, Honduran farmers predominantly grow basic grains because horticultural crops require more sophisticated techniques and infrastructure for both their production and marketing. In addition, lack of access to credit makes it more difficult for farmers to meet the higher working capital requirements of horticultural crops, and poor transportation infrastructure increases the costs of getting crops to market and inputs to the farm gate.

Activities under this Project include:

1. Farmer Training and Development: Technical assistance in the production and marketing of high value horticultural crops;
2. Farmer Access to Credit: Technical assistance to financial institutions to strengthen credit risk assessment skills, loans to such institutions to improve the availability of funds for rural financial institutions, and expansion of the national lien registry system to improve the environment for asset-based lending;
3. Farm to Market Roads: Construction and improvement of feeder roads that connect farms to markets; and
4. Agricultural Public Goods Grant Facility: Support for the adaptation of global technological advances to local Honduran conditions and investments that improve the agricultural productivity of large groups of farmers (e.g., irrigation infrastructure, post-harvest facilities, watershed management, etc.).

Benefits: The Project will improve the business skills, productivity, market access and risk management practices of producers who operate small- and medium-size farms. This will result in higher incomes for the targeted farmers, their employees, and their communities and strengthen the capacity of those enterprises servicing horticultural production and trade.

B. *Transportation Project (\$125.7 million over 5 years)*

High transportation costs are a significant impediment to economic growth, particularly for agriculture and light manufacturing. Of particular importance for commercial activity is the Atlantic Corridor highway, which includes the Highway CA-5 linking the Atlantic port of Puerto Cortes to the major production and consumption centers in Honduras, El Salvador and Nicaragua. This road carries most of the country's import and export traffic and accounts for 23 percent of highway traffic volume. After more than 30 years of service, the road needs improvements as service levels have declined drastically on some stretches and road safety is poor. In addition, the lack of a system for controlling vehicle weights has contributed to the deterioration of roadways, increasing the cost of maintenance and reducing safety.

Activities under this Project include:

1. Highway CA-5: Improvement of two stretches of the Highway CA-5;
2. Secondary Roads: Upgrade of key secondary routes to improve the access of rural communities to markets; and
3. Weight Control System: Construction of an effective weight control system, and issuance of contracts to operate it effectively.

Benefits: This Project will reduce transportation costs and allow the economic development that has primarily occurred within the urban area of the Department of Cortes to expand to other parts of the country. This will help Honduras, Nicaragua and El Salvador fully realize the benefits of

DR-CAFTA. The weight-control project will help to preserve the improved condition of the roads.

C. *Measuring Outcome and Impact (\$5 million)*

The purpose of the Monitoring and Evaluation (M&E) Plan is to provide information to MCA-Honduras (discussed in Section D below), MCC, and other interested parties on the pace of implementation, progress toward meeting the Objectives of each Project, and the impact on the Program Goal of increasing the incomes of beneficiaries.

Monitoring Plan: Indicators measuring the pace at which goods and services are delivered under a Project will be monitored to inform whether the implementation of Projects is progressing according to schedule. Other indicators will measure intermediate results to determine whether these delivered goods and services are having the intended effects. Finally, Program beneficiaries' income will be measured to inform the MCC of the final impact of the Program as well as inform the design of future Compacts and other donor programs. To measure the impact of the Program, the M&E Plan will require baseline data for each Indicator to provide a comparison with data measured during and after the Program. Indicators will be disaggregated by gender, income level and age, to the extent practicable.

Measures of Success: The principal indicators are (i) at the overall Goal level, an increase in annual income of beneficiaries of \$69 million by the end of the Compact; (ii) for the Agriculture Project, an increase in number of farmers and number of hectares involved in harvesting new high value horticulture crops of 8,000 and 14,000, respectively; (iii) and for the Transportation Project, an increase in road use of 13 percent on main roads and 31 percent on secondary roads, with a decrease in freight costs on main roads of 9 percent.

Evaluation Plan: Evaluations will seek to understand and quantify the impact of the Program, including the channels through which the Projects make an impact. Data analysis will be carried out by MCA-Honduras, MCC and contracted entities unrelated to MCC or MCA-Honduras. The MCA-Honduras Program Management Unit ("*PMU*"), and in particular the Monitoring and Evaluation Coordinator therein, with approval from MCC, will be responsible for ensuring that all necessary data for evaluating impact is collected.

D. *Program Management (\$9.3 million)*

MCA-Honduras, a legal entity comprised of a Board of Directors ("*Board*") and the PMU, will be established to implement the Compact and is the entity ultimately responsible for Program success. The duties of MCA-Honduras will include program management, financial management and reporting, and coordination of monitoring and evaluation. The Board will be composed of five voting members, three of whom will be government ministers and two of whom will be selected from among the four observers to the Board who represent Honduran non-government organizations. The Board will have nine non-voting observers, eight of whom will be Honduran observers (i.e., four representatives from government ministries and four from

non-government organizations)¹ and one observer from MCC. The PMU will be composed of full-time professional staff that will provide daily management of the entire MCC Program. In addition to having observer status on the MCA-Honduras Board, MCC will retain approval rights at a number of key decision points during implementation, including key steps in procurements, budgets for Project Activities, major re-disbursements and key personnel decisions.

The principles, rules, and procedures set out in the Honduran Organic Budget Law and the Honduran Budget Execution Law will govern the management of MCC funds, subject to certain exceptions to be documented in the Fiscal Accountability Plan to be developed by MCA-Honduras and agreed to by the MCC. Project managers and/or the PMU, as appropriate, will approve requests for payments from implementing entities; however, neither will have direct access to Program funds. As a check and balance on the PMU, the Ministry of Finance will serve as the fiscal agent and will be the sole signatory to the MCA-Honduras bank account into which MCC funds will be disbursed. This Ministry is in the process of developing a new integrated financial management system, which is scheduled to be fully operational on January 1, 2006. In the interim period, the Ministry of Finance has developed special procedures to handle MCA funds, and it plans to establish a dedicated group to handle MCC transactions.

FONADERS, a public sector entity within the Ministry of Agriculture, will serve as the Project Manager for the Rural Development Project. The Transportation Project Manager will be contracted out under a competitive international tender. Most major Program procurements will be administered by the relevant Project Manager. The PMU will also procure small to medium value goods and services. At key points in procurement, MCC and MCA-Honduras will have the right to offer a “no objection” to ensure proper procurement processes are followed. Procurements will be conducted in accordance with World Bank procurement standards, except as MCC and the GOH otherwise agree.

III. Assessment

A. *Economic Analysis*

The economic rate of return (ERR) for the Rural Development Project is estimated to be 21 percent, calculated as a weighted average of each component. The return to the Farmer Training and Development activity was estimated to be 36 percent based on actual crop profitability and projected project costs. The activities to improve access to credit were assumed to only benefit the farmers in the Farmer Training and Development activity, which underestimates the benefits from this activity. As specific activities for the public goods grants and rural roads will be determined over the course of the Project, their benefits were assumed to be the minimum required by their respective selection mechanisms, 15 percent for public goods grants and 12 percent for rural roads. The minimum required rate of return was based on the past performance of similar projects. If the selection criteria are adhered to for the roads and public goods, the observed return will likely exceed our ex-ante estimates.

¹ There will be four non-government organizations represented on the Board, two as voting members and two as observers. The four non-government organizations will rotate between observer and voting status.

The economic benefits from the Transportation Project derive both from the direct benefits of reduced transportation costs and from the stimulus to new investment from lower transport costs. The ERR for the Transportation Project is estimated to be 25 percent. This return is the weighted average of the returns for the three activities: Highway CA-5 (21 percent), Secondary Roads (40 percent), and Weight Control (25 percent)². The stimulation of new businesses and investments due to lower transport costs are more difficult to measure, but are likely to be an important part of the economic benefits. Sectors whose ratio of transport costs to production price is relatively high, such as the light manufacturing sector and agriculture, are likely to receive new investments as a result of improved infrastructure. If the improvements in the Highway CA-5 were to increase light manufacturing growth from 5 to 7 percent for the period 2007-2015, the return would increase by 7 percentage points to 28 percent. Improved transportation can have additional benefits through increased school enrollment and improved health outcomes. These indirect benefits have not been factored into the economic returns, so the ERR mentioned above is likely an underestimate of the gains from the Project.

B. Consultative Process

In 2001, the Government developed a Poverty Reduction Strategy Paper (the “*PRS Paper*”) with the participation of a broad range of Honduran society to guide the allocation of public resources to reduce poverty in Honduras. The consultative process of the PRS Paper included attendance by 3500 representatives of civil society organizations in 13 cities. Then, following consultations with national interest groups, the Government developed a Poverty Reduction Strategy - Implementation Plan for 2004 – 2006 (the “*PRS Plan*”) to prioritize the development goals of Honduras under the PRS Paper and to organize national resources and donor support to achieve such goals for the 2004-2006 period. The PRS Plan summarized findings from four workshops that the Government conducted in the main geographical regions of the country. The workshops included more than 650 participants and allowed the Government to receive feedback on the PRS Plan. In June 2004, the Government publicly presented the PRS Plan to the donor community in the Consultative Group meetings held in Tegucigalpa.

In developing the MCC Proposal, the Government used the priorities established in that PRS Plan and then posted the Proposal on its PRS web site (www.sierp.hn) to solicit feedback from the public at large. In addition, a summary of the Proposal appeared in a major local newspaper with the web address of the full Proposal. After submitting the Proposal to MCC, the Government held five high level meetings with the business community, civil society, non-governmental organizations, and donors, during which participants offered their insights on obstacles to economic growth and poverty reduction in Honduras.

This input along with other factors contributed to several material changes on the Program including: the inclusion of civil society as voting members of the Board of MCA-Honduras, the elimination of the tourism and urban development components, and the expansion of the geographic scope of the Rural Development Project. The GOH also has held meetings with civil society, donors, and the private sector to explain how the comments it has received have caused

² Based on the direct benefits accrued from reduced travel time, reduced vehicle operating costs, and reduced road maintenance.

the final MCC Program to differ from the original proposal. There is broad agreement among the Hondurans and donors that raising agricultural productivity and reducing transportation costs are priorities for addressing poverty reduction through economic growth.

In conducting due diligence on the GOH's consultative process for the PRS and for the MCC Proposal, representatives from MCC met with a wide selection of civil society, including international NGOs, domestic national associations of civil society groups, and domestic NGOs. Most of these groups saw the PRS process as a more transparent and participatory mechanism for setting policy priorities and coordination cooperation with donors than had previously existed.

The GOH plans to continue consultations at the project level, both in the transportation and agriculture sectors, throughout implementation. In addition, civil society representatives will participate on the MCA-Honduras Board as voting members and observers to ensure civil society oversight and input throughout the process.

C. *Government Commitment and Effectiveness*

The MCC Program has received a significant level of government attention from a number of ministers and their staff. The presence of the Minister of the Presidency and several other Ministers on the MCA-Honduras Board will contribute to on-going high-level attention to implementation of the Compact. The Government of Honduras has also committed to make several reforms as part of the Compact. These reforms include passing and enacting several laws which relate to MCC qualification criteria and to the implementation of components of the Compact (e.g. vehicle weight limit regulations, road maintenance, and a law to improve the process for pledging and liquidation of guarantees).

D. *Sustainability*

In the Rural Development Project, the key issue for sustainability will be ensuring that participating farmers are able to maintain the same level of productivity and expand their businesses once they have graduated from the program. Marketing and agro-export businesses are willing to provide technical assistance and inputs to established farmers, and those farmers who have made successful use of this technical assistance will have higher incomes from which to pay for periodic seminars to stay current with innovations. In addition, the Project will create a larger demand for financial services, leading to the development by banks of financial products and expertise to service this growing market.

In the Transportation Project, a key issue for sustainability is road maintenance. A condition in the Compact for disbursement of funds is that the GOH meet defined funding and maintenance targets for the road network. Road maintenance is presently funded by budgetary transfers to the Road Fund, which was established in 1998. Annual transfers presently stand at \$37 million, just short of the \$40 million estimated cost of routine maintenance for 100 percent of the paved network and 50 percent of the unpaved network. Prior to the disbursement of funds for the upgrading the Highway CA-5, the GOH will have to present an acceptable plan for road maintenance that details the required maintenance, associated costs and sources of funding.

E. *Environment and Social*

Due mainly to the farm to market roads, the Rural Development Project is a “Category B” project with potentially adverse environmental impacts which are site-specific and largely mitigable. The Compact requires environmental review, and funding for any roads will be contingent on the issuance of an environmental license, where needed, and any other required permits. The Compact also describes the environmental and social sustainability principles that will guide the work of agricultural technical assistance providers as well as other activities under the Rural Development Project.

The Transportation Project is a “Category A” project with respect to its environmental and social impact. While the majority of the impacts of the upgrade to the Highway CA-5 are site-specific and relatively easily mitigated, the project involves the clearing of rights-of-way that will require compensation of at least 226 affected parties. The Compact requires adherence to World Bank Operational Policy 4.12 on Involuntary Resettlement. Two environmental impact assessments (EIAs) were undertaken in accordance with Honduran law, one for each of two segments of road to be improved and environmental licenses have been granted. As this is an existing main transport corridor and is already degraded, both EIAs conclude that the main impacts will occur during construction and are largely mitigable. The environmental licenses for the project have already been issued and made public together with the required mitigation measures. MCC will require publication of the EIAs and that detailed environmental management plans be satisfactorily completed as a condition for disbursement of funds for construction.

F. *Donor Coordination*

The proposed Projects complement and supplement efforts by other donors. The Honduran PRS calls for increasing rural incomes and financing infrastructure. USAID, USDA, the World Bank, the Inter-American Development Bank (IDB), IFAD, and the Canadian International Development Agency are all active in supporting various rural development activities. Work to upgrade the Honduran Atlantic Corridor is being coordinated by the Honduran Ministry of Roads and funded by the World Bank, the IDB, and the Central American Bank for Economic Integration. The MCC Program will fund the upgrade of the final section of the Atlantic Corridor highway. In addition, the IDB and World Bank have funded projects to strengthen the capacity of the Ministry of Roads, and the World Bank funded the designs and environmental impact studies for the sections of the road that MCC will be funding.