PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: AB7653

Operation Name	Honduras Fiscal Sustainability and Enhanced Social Protection
Region	Latin America and the Caribbean
Country	Honduras
Sector	Central government administration (60%); General public administration sector (40%)
Operation ID	P151803
Lending Instrument	Development Policy Credit
Borrower(s)	Republic of Honduras
Implementing Agency	Secretariat of Finance
Date PID Prepared	October 14, 2014
Estimated Date of Appraisal	November 3, 2014
Estimated Date of Board Approval	December 11, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

Honduras is a lower middle income country with a GDP of about US$19 billion and a per capita gross national income (GNI) of US$2,180, compared to a Latin America and the Caribbean (LAC) average of US$9,000. Honduras is the second most populated country in Central America with a multi-ethnic population of 8 million, and the second largest in size, with an area of 112,088 square kilometers. Almost half of the population lives in rural areas, practicing subsistence agriculture. Persistent economic and social challenges have affected the population's trust in the Government's capacity to eradicate poverty and boost shared prosperity. Meanwhile, the country faces a challenging security situation, with one of the highest homicide rate in the world. Following the global financial crisis, the economy experienced a modest and uneven recovery. After contracting by 2.9 percent in 2009, real GDP growth rebounded modestly, averaging 3.8 percent from 2010-12, below pre-crisis levels of 5.9 percent during 2003-2007, then slid to 2.6 percent in 2013. Honduras' current weak economic growth is not sufficient to significantly reduce poverty and inequality levels, highlighting the importance of improving the focus of social programs on vulnerable groups.

Honduras is one of the poorest and most unequal countries in the region. The poverty rate in Honduras is 64.5 percent using the national poverty line. Extreme poverty affects more than 40 percent of the population. Income inequality is also one of the highest in LAC, with a Gini coefficient around 0.57 and hovering at this level for more than two decades. Public spending on social sectors is high by regional standards, at around 15 percent of GDP. However, Honduras' Human Opportunity Index (which measures the degree of equity in the access to basic goods and services) is among the lowest in LAC, hinders economic opportunities, particularly for the most vulnerable, and is due to the limited effectiveness of public expenditures. In recent years targeted social programs have contributed to reducing poverty, and enhanced fiscal controls and policy management could generate fiscal space to support government efforts in this area.

Serious fiscal challenges put at risk social spending and raise concerns about Honduras' ability to break from high levels of poverty and inequality. Fiscal instability intensifies poverty, first because the consequent macroeconomic instability hits the poor hardest, and hinders savings, investment, and growth; and second, because it severely limits the fiscal space available for targeted programs. Honduras has suffered from varying degrees of fiscal instability for the last two decades. In 2009 Honduras' fiscal position deteriorated significantly due to the negative impact that the global financial crisis had on exports, remittances, availability of credit, and FDI flows which in turn affected growth and tax collection. In the case of Honduras, the impact of the global crisis was compounded by a political crisis in 2009, which, in addition to its negative impact on the investment climate, resulted in the temporary suspension of aid from most of the international community. Following the crisis, fiscal consolidation efforts resulted in a partial recovery in economic growth and the country's fiscal and external stance. However, the fiscal situation deteriorated again significantly during 2012-2013, mainly due to a lack of fiscal discipline in a context of worsening terms of trade. The Central Government fiscal deficit increased from 2.4 percent of GDP in 2008 to 7.9 percent in 2013, higher than the 6 percent deficit in 2009 associated with the global financial crisis and the domestic political crisis.

The Government of Honduras has articulated a comprehensive reform program and has taken a series of corrective measures with the aim of stabilizing its fiscal position. Since December 2013 the administration began setting the building blocks for sustained economic stability and while many structural challenges remain to be tackled, the actions taken in recent months represent important steps in the right direction. A tax reform is expected to mobilize more than 1.9 percentage points of GDP of revenues in 2014, relative to the average of the previous three years. To reduce the fiscal gap, the Government has taken actions to contain spending by enhancing public investment controls and freezing the hiring of new staff. Furthermore, the Government embarked on an integral reform of the power sector, which in 2013 represented a direct fiscal impact (both government spending and unrealized revenue) of 1.8 percent of GDP. Moreover, to reduce the impact of fiscal consolation efforts on the most vulnerable, the Government is improving the targeting, monitoring, and evaluation of social protection systems.

Multilaterals are supporting this reform program designed to attain fiscal sustainability, reduce debt, restore confidence, and build the foundations for economic growth and enhanced opportunities for the most vulnerable. This operation is being prepared in coordination with a number of development partners, including the International Monetary Fund (IMF) and the Inter-American Development Bank (IDB). In this regard, the program supported by the World Bank represents part of a larger reform agenda being supported by International Financial Institutions (IFIs). While accelerating growth rates and reducing poverty in the short-term is a difficult proposition, this reform agenda, if sustained, could significantly transform the policy and institutional landscape in Honduras, promoting investment and job creation, and strengthening the delivery of public services.

The proposed Development Policy Credit (DPC) is an opportunity to support structural reforms but faces high risks. The Government has shown a strong commitment to mitigate these risks in implementing the reform program with broad political agreement regarding its policy objectives. Risks stem mainly from (i) macroeconomic shocks; (ii) a potential loss of reform steam if initial results are not sufficient to maintain political support; and (iii) limited implementation capacity that could slow the pace of reform. In this regard, the Government has taken a series of steps to mitigate those risks, such as the reorganization of the administration to ensure and enhance implementation, and supervisory arrangements across policy areas, including the creation of an Economic Coordination Cabinet. In addition, the authorities are following a continuous consultation and awareness-raising process and have taken a number of actions that are evidence of its reform commitment, including: a tax reform, the development and adoption of a human resource registry, and a number of important governance-enhancing legislations in the fields of public finance, energy, and social protection. Additionally, the World Bank Group is engaged in a series of analytical and technical assistance activities in support of envisaged reforms in this DPC in the areas of economic governance, energy management, poverty and equity monitoring, and competitiveness.

II. Proposed Objective(s)

The Program Development Objective of the Development Policy Credit is to support the Government of Honduras to reverse the current fiscal deterioration while protecting the most vulnerable with a focus on three pillars: (i) strengthening fiscal and financial management; (ii) strengthening the management of the power sector; and (iii) improving the targeting of social protection programs.

III. Preliminary Description

The World Bank proposes a Development Policy Credit (DPC) in the amount of US$55 million equivalent to the Republic of Honduras. The proposed stand-alone operation supports the Government of Honduras' ongoing efforts to tackle an ongoing difficult fiscal situation paired with high levels of extreme poverty. Achieving fiscal sustainability and good progress on structural reforms is critical to leverage opportunities that could help the country escape from a cycle of low growth, high levels of public debt, high unemployment, and high extreme poverty. The reforms supported by this operation are part of the *Plan de Todos para una Vida Mejor*, the government's strategy, which sets development goals for improved governance, human development, and security. The operation is fully consistent with the World Bank Group's Strategy and complements efforts of other development partners. It also builds on lessons learned and progress achieved under previous World Bank Group operations.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Government actions supported in this DPC are expected to have overall positive poverty and social impacts. The analysis carried out on the potential impacts of the reforms supported under this operation suggests a positive or neutral impact for the reforms supported under this operation. Notably, given the precarious fiscal situation facing Honduras, reforms supported under each of the three policy pillars of this operation focus on generating more fiscal space while targeting expenditures to the extreme poor. Concerning Pillar 1, "Strengthening Fiscal and Financial Management", reforms supported by this operation are aimed at enhancing economic governance to support fiscal consolidation efforts and promote transparency and accountability in public spending. Concerning Pillar 2, "Strengthening the Management of the Power Sector", reforms supported by this operation are aimed at enhancing institutional capacity to help reduce the financial loses of the state-owned Electricity Company, and thereby complement fiscal consolidation efforts. Finally, concerning Pillar 3, "Improving the Targeting of Social Protection Programs," reforms supported by this operation aim to help ensure that social programs channel resources to those in most need. The program document of this operation will provide an assessment of the expected poverty and social impacts for each of the reforms supported under this operation.

Environmental Aspects

The measures supported under the proposed DPC are not likely to have significant effects on the environment, forests or other natural resources. Pillar 1 and Pillar 3, "Strengthening Fiscal and Financial Management" and "Improving the Targeting of Social Protection Programs", have a primarily administrative nature, therefore policy actions under the first pillar are unlikely to either exacerbate environmental problems or contribute to their remediation. Pillar 2, "Strengthening the Management of the Power Sector", supports policies promoted by an ongoing World Bank investment operation in the energy sector and encompasses policy actions for the state-owned Electricity Company that are not expected to have implications on changing sources of electricity that could have an impact on environmental sustainability.

V. Tentative financing

Source:		($million)
BORROWER/RECIPIENT		0
International Development Association (IDA)		55
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	55

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