PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB7666

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
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Corporate Review Decision	October 28, 2014.

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 at 82.4 homicides per 100,000 inhabitants (2010). 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 fiscal space and 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 space to support government efforts in this area.

Serious fiscal challenges raise concerns about Honduras' ability to break from high levels of poverty and inequality, putting at risk social spending. 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. Recently, this has become chronic. Honduras' fiscal position deteriorated significantly in 2009 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 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 1.8 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. Reforms to the power sector included: (i) the adoption of a new legal framework for electricity generation, distribution and commercialization; (ii) the reduction of regressive subsidies for electricity consumption; (iii) the award of trustees to two local banks in order to minimize the financial losses of the state-owned Electricity Company (ENEE); and (iv) institutional reforms to improve the management of the power sector. 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) faces high risks. The Government has shown a strong commitment to mitigate these risks and to implement the reform program, and there is broad political agreement regarding its policy objectives. Risks stem mainly from (i) economic shocks; (ii) a potential loss of reform steam if initial results are not sufficient to maintain political support; (iii) limited capacity that could slow the pace of the reform; and (iv) natural disasters. 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, which include the creation of an Economic Coordination Cabinet, the creation of an Energy Reform Commission, and the creation of a Reform Council to lead the public wage expenditure review strategy. In addition, the authorities have been taking a number of actions since December 2013 that are evidence of its commitment to the reform. These actions entail a tax reform, the construction of a human resource registry, and a number of important legislations in the fields of procurement, energy, and social protection. Additionally, the World Bank and the International Finance Corporation envisage a series of analytical and advisory activities in support of the DPC program in the areas of economic governance, poverty and equity monitoring, and competitiveness.

II. Proposed Objective(s)

The Program Development Objective of the Development Policy Credit (DPC) is to support the Government of Honduras to (i) strengthen fiscal and financial management; (ii) strengthen the management of the power sector; and (iii) improve 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, and to launch structural reforms. 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 positive poverty and social impacts, primarily through strengthened fiscal stability. The analysis carried out on the potential impacts of the reforms supported under this operation (presented in Annex 4) suggests a positive or neutral direct impact for the reforms supported under this operation. While cost-saving measures may result in a short-term economic contraction, on net, they are expected to increase the long-term sustainability and targeting of public spending while preserving the fiscal space necessary to provide the poorest with a resilient safety net.

Reforms aimed at reducing wage expenditures and improving the efficiency of the Government's payroll system are unlikely to have a direct impact on the poor and vulnerable. The impact of any resulting reduction in public wage expenditures is expected to mainly impact the upper part of the income distribution and is unlikely to have a direct impact on the poor and vulnerable. Only 3 percent of workers in the bottom 40 percent of the income distribution are employed in the public sector (compared to 18 percent of those in the top 60 percent). While procurement reforms may result in lower government purchases from private sector companies, in the medium-term, however, both of these reforms may lead to productivity increases as the crowding out effect of redundant or inefficient government spending is reduced. Additionally, reforms aimed at improving the efficiency and transparency of procurement and public payroll systems may lead to increases in citizens' trust in the government and the public sector.

The reforms of ENEE supported by this DPC will contribute to improved fiscal sustainability by reducing the electricity company's losses through improvements in management, cuts in subsidies, and increases in prices paid by consumers. Due to the regressive nature of energy subsidies and the low access to electricity among the country's poorest, the direct impact of the action supported under this operation on the extreme poor is expected to be positive overall. The coverage of the subsidy has been decreased by 40 percent and now focuses on residential consumers with usage of less than 75 kWh per month, thus increasing the progressivity of this subsidy. Importantly, the ongoing restructuring of the ENEE, in part supported through prior actions undertaken as part of this DPC, is expected to lead to increases in the company's technical and managerial capacity. This is an important step towards addressing the high public costs associated with this sector. Overall, these measures are expected to promote the financial sustainability of the power sector thereby creating space to improve access to electricity for the poor over the medium term.

Indirectly, and importantly, the creation of fiscal space made possible by these reforms is likely to be pro-poor to the extent that these cost saving measures will reduce the need to cut public transfer spending needed by the poor. In 2013, 2 percent of Honduras' public sector spending was debt servicing, which has limited the country's ability to address pressing social needs in the face of high poverty, inequality and insecurity. In addition, the continued high deficits facing the country endanger and weaken the current social safety net. For example, benefits for the primary CCT program are often not disbursed, or are not disbursed on schedule, limiting the ability of recipient households to budget and plan accordingly.

Measures related to social protection programs are expected to generate positive impacts for the extreme poor. A better targeted public transfers program is expected to be more progressive as it will help ensure that resources are channeled to those most in need and who will benefit most from public social expenditures. The magnitude of the impact of actions under Pillar 3 will depend on the implementation of the new targeting formula for social programs. Nonetheless, the development of tools to improve the monitoring and evaluation of social programs, including the new targeting formula for social programs and the creation of the RUP are important milestones to reduce extreme poverty in Honduras. Indeed, evidence from other countries emphasizes the positive impacts of improving such monitoring and evaluation systems to ensure that households receive all benefits for which they are eligible. The RUP is also expected to improve inter-ministerial coordination mechanisms for social policy.

Environmental Aspects

The measures supported under the proposed DPC are not likely to have significant effects on the environment, forests or other natural resources. The first and third pillars, Strengthening Fiscal and Financial Management and Improving the Efficiency 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. The second pillar Strengthening the Management of the Power Sector, supports policies promoted by the World Bank investment operation PROMEF and encompasses policy actions for ENEE 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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