PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB6027

Operation Name	Honduras: Fiscal Emergency Recovery Development Policy Credit
Region	LATIN AMERICA AND CARIBBEAN
Country	HONDURAS
Sector	Central Government Administration (100%)
Operation ID	P121220
Lending Instrument	Development Policy Credit
Borrower(s)	REPUBLIC OF HONDURAS
Implementing Agency	MINISTRY OF FINANCE
Date PID Prepared	September 22nd , 2010
Date of Appraisal Authorization	September 13th, 2010
Estimated Date of Board Approval	November 9th, 2010
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation

1. Key development issues and rationale for Bank involvement

The fiscal challenges that the Lobo administration is facing are the result of a combination of factors: the global crisis, the country's political crisis, and pre-existing structural problems. As in many other countries, the fiscal situation deteriorated significantly in 2009. This was the result of the negative impact that the global 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 the political crisis which, in addition to its negative impact on the investment climate, resulted in the temporary suspension of aid from most of the international community. On the spending side, the application of a special labor regime for teachers (the so-called *Estatutos* approved in 1998) had resulted in recent years in large increases in the wage bill (which by 2009 it absorbed about 80 cents of each tax dollar collected) significantly limiting the space of the Government to adjust. Lower tax collection and availability of financing, a very rigid budget and, more generally, a lack of spending discipline during 2009 resulted in the build-up of substantial arrears estimated at around 5 percent of GDP by end 2009. Moreover, the political decision to withdraw from ALBA in January 2010 curtailed an important source of projected financing originating from Venezuela.

In order to avoid a full-blown fiscal crisis, the Lobo administration has taken a series of decisive corrective measures that will help stabilize the fiscal situation*.* The Government's fiscal consolidation efforts are being discussed with the donor community, including the Bank, the IMF and the IDB, in order to secure financial and technical support. The Government's strategy includes tax reforms (expected to yield 1.0-1.5 percent of GDP annually), and spending cuts (2 percent of GDP), and considers measures to control public sector wages, especially teacher salaries (about 1 percent of GDP). Together with the expected recovery of the Honduran economy in 2010-11, these measures should be sufficient to bring the fiscal situation under control. While many structural challenges remain to be tackled, the actions taken by the Government in recent months are an important first step.

However, until the full impact of the reforms is observed, Honduras will need substantial donor support. Given that some of the introduced reforms will not have a full impact this year, the country still faces a significant financing gap for 2010, and the Government is relying on support from the donor community. This operation is being prepared in coordination with a number of other donors such as the Inter-American Development Bank (IDB), the European Union (EU), and the Central American Bank for Economic Integration (CABEI) who are preparing similar operations, and with the IMF. The Fund's Board will consider a new Stand-by Arrangement (SBA) on October 1, 2010.

The Government is aware that the needed fiscal adjustment will not be painless. However, it is confident that the recently launched Conditional Cash Transfer Program (*Bono 10,000*) will be able to offset many of the negative impacts of the adjustment on the poor. By end-2010, the Program is expected to cover about 150,000 families living in extreme poverty. The Bank is supporting the *Bono 10,000* through the recently approved Social Protection Project.

2. Operation objective(s)

The operation's Development Objective is to assist the Government in bringing public finances back to a sustainable path**..** Specifically, the operation supports four areas that are central to the reform program. (i) tax reform, including closing tax loopholes, widening some tax bases, and improving tax administration; (ii) civil service reform, focused on human resource management in the education sector and a rationalization of the public wage bill; (iii) reform of power sector tariffs to support the financial sustainability of the state-owned electricity company; and (iv) strengthening public financial management and transparency by resolving outstanding public sector arrears and investigating the shortcomings of the financial management information system. The DPC operation also supports the macroeconomic stability and growth objective of the Interim Strategy Note.

3. Institutional and Implementation Arrangements.

The Ministry of Finance (SEFIN) is responsible for the implementation of the DPC operation as well as for coordinating the actions among the concerned agencies, including the Central Bank of Honduras, the Ministry of Education and the Ministry of Planning. Together with SEFIN and the National Institute of Statistics (INE), these institutions collect the necessary data for the identified monitoring indicators. The SEFIN and the Bank have agreed to monitor the progress in the program supported by the DPC and its evaluation will serve to inform preparation of a new Country Partnership Strategy.

4. Risks and Risk Mitigation.

The DPC is subject to four main risks: political, institutional, economic and environmental.

On the political side, the main risk derives from the Government's ability to complete the implementation of the fiscal reform package. With a polarized society following the political crisis of 2009, approval and implementation of the planned fiscal package could be more difficult than anticipated and therefore jeopardize the needed fiscal adjustment. In order to reduce this risk, the Government has been building consensus in society for the need to implement the reforms to bring the country's finances back to a sustainable path.

On the institutional side, the main risks derive from the weakness in the capacity of the Government's institutions to implement the reforms. In order to reduce this risk, the Bank is working with other donors to support the Government's fiscal consolidation efforts, including through technical assistance.

On the economic front, the main risk derives from the slow recovery of the global crisis. To the extent that the global slowdown lasts longer than expected, there is a risk that the fiscal situation will remain difficult and poverty and unemployment levels fail to decline significantly. The possibility of a prolonged economic slowdown has been incorporated into the macroeconomic projection and the Bank and the Fund are maintaining an on-going dialogue with the authorities on macroeconomic policy issues.

On the environmental side, the main risks derive from the country's high exposure to multiple natural disasters. Honduras has been hit by multiple hurricanes in recent years which resulted in significant damage. The country's past experience has highlighted the value of investing early warning systems, institutional strengthening and mitigation efforts. Building on the progress made to date in this area, the Bank is providing both lending resources and analytical support to strengthen the country's natural disaster mitigation systems.

5. Poverty and Social Impacts and Environment Aspects.

Poverty and Social Impacts

The reforms of electricity tariffs are likely to affect primarily the richer population. A distributional analysis conducted by the IMF in 2008 showed that electricity subsidies consumed three-quarters of total grants and are poorly targeted, and that almost half goes to consumers in the highest income quintile. An estimate using the household survey data shows that only the richest 30 percent of the population consumes more than 150 kWh per month (see Figure 1) and will therefore be affected by the elimination of the electricity subsidy. The impact of the 12 percent value-added tax on electricity will be even more concentrated, since only the richest 1 percent of the population consumes more than 750 kWh per month. Similarly, the increase in electricity tariffs will affect these higher income groups more than the lower income groups, who will remain protected by the subsidy. The resulting expenditure on electricity consumption is depicted in Figure 2.

The bulk of the impact of the three reforms combined, VAT reform, teacher's salary freeze and electricity tariff reform, will fall on the top 50 percent of the income distribution. Therefore, the reforms are progressive. Moreover, as one can see from Figure 3, the Government's conditional cash transfer program is likely to more than compensate the bottom 40 percent of the income distribution for the increase in cost of living caused by the reforms. Thus, the net effect of the combined reforms *and* the CCT program is likely to be a reduction in extreme poverty and inequality. Nevertheless, moderate poverty rates may increase, despite the drop in inequality, because households of the 5th and 6th deciles of the income distribution, which are closest to the moderate poverty line, are unlikely to be fully compensated by the CCT.

Figure 1: Energy consumption by income decile (kWh per month)

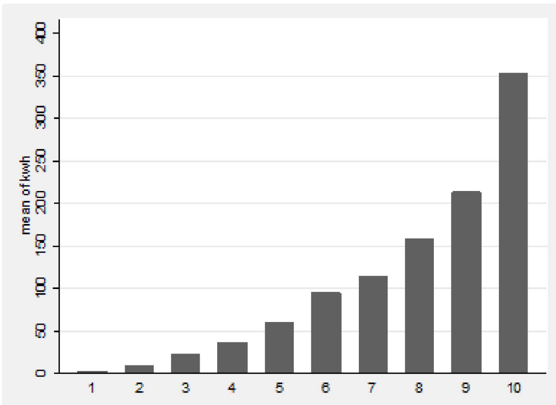


Figure 2: Cost of electricity consumption: current and proposed

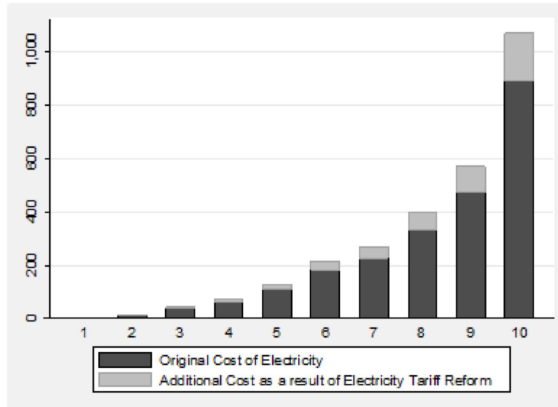
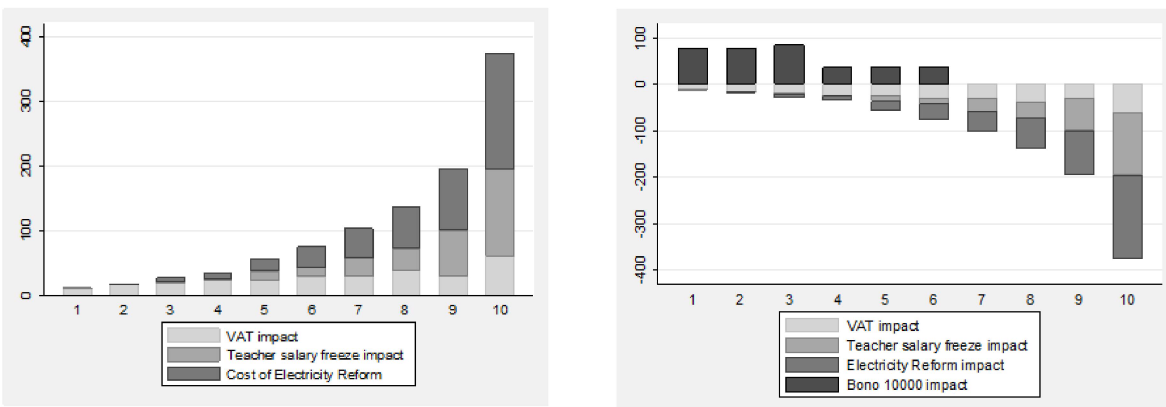


Figure 3: Effect of reforms by income decile



Source: Staff calculations based on household survey

The implementation of the findings by the Supreme Audit Court could lead to class disruptions in public schools. The magnitude of the impact will depend on the number of teacher's positions affected and the likely response by the Teacher Unions. To mitigate this risk, the Government has reached an agreement with representatives from the Teachers Unions to create and integrate a Special Committee who will study the recommendations by the Supreme Audit Court and, within a two month framework, present a final report with an agreed action plan to address these recommendations.

Environment Aspects

While the electricity tariff reforms may have a beneficial impact, the overall reform program supported by the proposed operation is not likely to produce significant impacts on the environment, forests or other natural resources. The tax reforms supported by this operation are not likely to have any significant positive or negative effects on the environment, as the tax reforms are not pertinent to environmental regulations. Similarly, the prior actions related to civil service reforms pertain to the education sector and are not likely to have significant positive or negative effects on the environment. Electricity tariffs in Honduras are below the cost recovery level and do not reflect the economic costs of supply. The low electricity prices seem to have induced higher electricity consumption per household compared to other countries in the region. A reduction in subsidies would translate into reduced electricity consumption and reduced green-house gas emissions, considering more than 60 per cent of total generation in Honduras is based on hydrocarbons. In addition, the exemption of the value-added tax on electricity consumption contributes to the substitution of LPG gas, which is taxed, for electricity for cooking and water heating. Energy in the form of electricity is more costly for society, but its price is lower, which has been the main factor in the great popularity of electric stoves and electric water heaters in Honduras.

6. Tentative financing

Source:	($m.)
Borrower	0
International Development Association	74.7
Total	**74.7**

7. Contact points

Contact: Christian Gonzalez
Title: Economist
Tel: 202-473-6135
Email: cgonzalez@worldbank.org

Contact: Humberto Lopez
Title: Lead Economist and Sector Leader, PREM
Tel: 202-473-4909
Email: hlopez@worldbank.org