PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: 101033

Operation Name	First Fiscal Sustainability and Enhanced Competitiveness Development Policy Financing
Region	Latin America and the Caribbean
Country	Honduras
Sector	Central government administration (60%); General public administration sector (40%)
Operation ID	P155920
Lending Instrument	Programmatic Development Policy Financing
Borrower(s)	Republic of Honduras
Implementing Agency	Secretariat of Finance
Date PID Prepared	November 6, 2015
Estimated Date of Appraisal	November 4, 2015
Estimated Date of Board Approval	December 15, 2015
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Background

Honduras is a lower middle income country with a GDP of about US$20 billion and a per capita gross national income of about US$2,300, compared to a Latin America and the Caribbean (LAC) average of US$9,000. Honduras is a multi-ethnic country with a population of about 8 million, and, with an area of 112,088 square kilometers, it is the second largest in size in Central America. Almost half of the population lives in rural areas, many relying on subsistence agriculture.

Honduras has one of the highest poverty rates in the Western Hemisphere. Nearly one in five Hondurans lives on less than US$1.90 (based on 2011 purchasing power parity) per day, the second highest rate in Latin America and the Caribbean (LAC). According to official poverty lines, in 2013 almost 65 percent of Honduran households lived in poverty and 43 percent lived in extreme poverty, including two out of three rural Hondurans. While poverty fell steadily in LAC over the past decade and it moved towards becoming a middle class region, poverty gains in Honduras have been harder to advance and maintain and its middle class remains among the smallest in the region (Figure 1). During 2003 and 2007, when real GDP grew by 6 percent on average, new job opportunities led to a reduction in poverty and pro-poor growth of household incomes (Figure 2). However, following the political and economic crisis of 2009, when real GDP fell by 2.4 percent, a slow and uneven growth recovery led to a three-year increase in poverty and a fall in the real income of households. By 2013, poverty rates had returned to the levels seen in 2001. Public spending, including conditional cash transfers (CCTs), are contributing to reducing poverty, but coverage of public programs and targeting mechanisms could be further enhanced to ensure that the most vulnerable are protected more effectively and in a fiscally sustainable way.

As identified in the SCD, the country's high poverty rates are to a large extent the result of the low and volatile per capita income levels. Honduras per capita GDP is the third lowest in the LAC region. This is the result of relatively persistent low growth rates. Over the 1960-2014 period, Honduras average per capita income growth (1.2 percent) was well below the one observed in the low and middle income countries group (3.1 percent). Moreover, growth has been volatile with repeated stop-and-go episodes and fluctuations (as measured by the standard deviation of per capita growth) 70 percent higher than those in the low and middle income countries group.

The high levels of crime and migration flows are among the most significant challenges to growth and poverty reduction faced by Honduras. In large part due to its strategic location for drug traffickers, Honduras has been facing some of the highest rates of crime and violence in the world (in 2014, the homicide rate was 66.5 homicides per 100,000 inhabitants), which has wide implications for quality of life and business growth potential. Furthermore, the country faces high emigration rates, with almost a million Hondurans living outside of the country. Emigrants in turn send back to the country about 18 percent of GDP in remittances, the highest rate in Central America. Remittances have indeed been an important source of poverty reduction and income for the population. But remittances also affect labor supply dynamics (by increasing reservation wages) and impact the real effective exchange rate (creating Dutch disease type of effects, affecting competitiveness). Moreover, because of shortcomings in the investment climate, remittances have funded imports and construction rather than productive business ventures that could create jobs.

There is evidence that the quality of institutions, including economic institutions, is another element that needs to be considered to understand Honduras' low per capita income and high poverty levels. For example, there are different dimensions of institutional weakness that affect the country's economic performance including: (i) the quality of the regulatory framework which affects the ability of firms to compete and of new firms to enter existing markets; and (ii) the high correlation between the political cycle and the implementation of expansionary fiscal policies that had led to several instances of severe macroeconomic instability. Indeed, public sector imbalances, including losses from state-owned enterprises (SOEs), and high debt levels have destabilized the Honduran economy many times in the past, leaving little room for public investment, undermining growth, and perpetuating poverty. Despite benefiting from the Multilateral Debt Relief from the Heavily Indebted Poor Countries initiative, which cut the public external debt stock by half in 2005, debt accumulated rapidly following the 2009 crisis, and currently the Government is spending a higher share of its revenues to service debt payments than it had before the debt relief. Furthermore, the recent forced liquidation of Banco Continental (Honduras' eighth largest bank in terms of assets), resulting from a money laundering and drug trafficking investigation, highlights the importance of strengthening the quality of institutions to improve financial and macroeconomic resilience. The design of the proposed DPF series aims at addressing weaknesses in different dimensions of institutional quality.

The current administration is addressing existing challenges with a two-pronged strategy. On the one hand, recognizing (i) the interrelation of crime and migration flows; (ii) the regional nature of a problem that affects the Northern Triangle of Central America formed by El Salvador, Guatemala, and Honduras; and (iii) the magnitude of the required interventions to address the challenge, Honduras has partnered with El Salvador and Guatemala to articulate a common strategy, which is contained in the *Plan of the Alliance for Prosperity in the Northern Triangle.* On the other hand, on the domestic front, the country has been implementing a comprehensive reform program to address macroeconomic challenges. Strong political commitment and the solid implementation of an ambitious fiscal consolidation strategy has helped to reduce the fiscal deficit from 7.6 percent of GDP in 2013 to 4.3 percent in 2014 and a projected 2.7 percent in 2015. A combination of fiscal, administrative and regulatory reforms, supported by the Fiscal Sustainability and Enhanced Social Protection Development Policy Credit (DPC, P151803) approved in December 2014, contributed to that fiscal adjustment and led to improved investor confidence. Yet, the debt-to-GDP ratio that in 2011 was 32 percent will be above 50 percent by 2016, and unless the fiscal situation is carefully managed could become a problem.

II. Operation Objectives

The Program Development Objective of the Development Policy Financing (DPF) is to support the Government's efforts in (i) strengthening institutional arrangements to support fiscal sustainability; and (ii) enhancing the regulatory framework to promote competitiveness. The proposed first operation in a programmatic series of two development policy financing operations aims to support Honduras' efforts to advance fiscal sustainability and enhance competitiveness. The proposed series has been informed by the forthcoming Systematic Country Diagnostic (SCD), *Honduras: Unlocking Economic Potential for Greater Opportunities*, and is well aligned with the Government of Honduras' development plan (*Plan de Todos para una Vida Mejor*), and with the 2016-2019 World Bank Group's Country Partnership Framework.

III. Rationale for Bank involvement

The proposed operation supports the administration's efforts to manage the fiscal situation, to help build the basis for sustainable fiscal policies, and accelerate growth. In order to strengthen institutional arrangements to support fiscal sustainability, the DPF focuses on policy measures aimed at improving: (i) fiscal and financial management; (ii) energy subsidies and quasi-fiscal deficits; and (iii) the targeting and transparency of social spending. The DPF also supports actions to enhance competitiveness by: (i) improving the regulatory framework to foster competition; and (ii) promoting trade facilitation. The two pillars of the operation reinforce each other, with reforms supporting fiscal sustainability being complemented by measures to enhance the competitiveness of the economy. Both pillars are likely to raise investor confidence, making Honduras more resilient to shocks while promoting growth and poverty reduction. Moreover, the short-term economic costs of the fiscal adjustment would be to some extent mitigated through competiveness-enhancing structural reforms.

As in previous operations, this programmatic DPF series is part of a broader reform agenda supported by multilaterals. This operation is being prepared in coordination with the

International Monetary Fund (IMF) and the Inter-American Development Bank (IDB). The IMF is implementing a Stand-By Arrangement/Credit Facility for the period 2014-2017. The three institutions are providing technical assistance on a number of reforms, including on taxation, fiscal management, energy policy, social protection, and private sector development. Reforms in these areas, a subset of which are supported by this program, can lead to significant improvements in the fiscal position of Honduras while protecting the poor, and promote investment and job creation.

IV. Tentative financing

Source:		($million)
BORROWER/RECIPIENT		0
International Development Association (IDA)		50
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	50

V. Institutional and Implementation Arrangements

Honduras' Secretariat of Finance (SEFIN) is responsible for the implementation of the program supported by the proposed DPF. As the main implementing agency, SEFIN will coordinate with other Government ministries and agencies involved in the implementation of the DPF, in particular the Secretariat of Industry and Commerce, the Secretariat of Development and Social Inclusion, the Secretariat of Natural Resources and Environment, the Secretariat of Governance, the National Statistics Institute, and the state-owned Electricity Company ENEE. Together with SEFIN, these institutions will collect the necessary data to assess implementation progress and evaluate results.

VI. Risks and Risk Mitigation

The proposed DPF faces substantial 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) political disagreement or legislative gridlock that could threaten the pace of the structural reform agenda; (ii) macroeconomic risks stemming from external and domestic shocks, including natural hazards; and (iii) limited institutional capacity that could slow the pace of the reform. The Government has taken a series of steps to mitigate those risks. Specifically, the authorities (i) have implemented a continuous consultation process and raised awareness on key policy measures; (ii) are planning to maintain an adequate level of foreign-exchange reserves, which would serve as a buffer to mitigate shocks; and (iii) have reorganized the administration to improve implementation and supervisory arrangements across policy areas. In addition, reform implementation of this operation is being supported by technical assistance from the World Bank, IMF, IDB, and other development partners.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

This DPF supports actions that are expected to have largely positive or neutral direct effects on poverty in the short term but overall positive impacts in the long term through enhanced fiscal sustainability and competitiveness. The analysis carried out on the potential effects of the reforms supported under this operation (presented in the Program Document) suggests an overall positive direct effect on poverty. While some cost-cutting measures may result in changes in household income, the majority of actions will not have direct effects on household income in the short-term. On net, they are expected to increase the long-term sustainability and targeting of public spending while preserving the fiscal space necessary to build and sustain a resilient safety net.

Measures aimed at building fiscal resilience through improved fiscal and financial management are expected to have largely neutral effects but have the potential to be pro-poor. Prior actions 1, 3 and 4 aim, through improved budgeting and instruments to better manage public debt and public spending to enhance the ability of the state to plan and execute spending decisions, and protect the fiscal space needed for targeted programs to help the most vulnerable segments of the population. Issues with budgeting and limited fiscal space have undermined the effectiveness of public spending by, for example, reducing the frequency and reliability of public transfer payments and insufficiently investing in needed road maintenance. In addition, prior action 3 is expected to reduce borrowing costs through the publication of a debt issuance calendar that will increase the use of competitive auctions for public debt issuance. In 2014, over 2 percent of Honduras' GDP was spent servicing debt, representing a significant opportunity cost for a country facing serious social challenges—poverty, hunger, crime and limited access to basic services.

The reforms of ENEE supported by this DPF may have adverse effects on poverty in the short-term, but are expected to bring positive impacts over the medium- and long-term. As the reduction of subsidies will lead to higher residential electricity costs for some consumers, some households living in or near poverty will be negatively impacted in the short-term.[1] For example, a household consuming 100 kWh per month will see their electricity costs increase by 36 percent. However, this is mitigated by three factors: (i) households consuming less than 75 kWh will continue to receive direct subsidies; (ii) the new subsidies will be lower but more progressive, with the first 100 kWh per month subsidized at fifteen times the rate of the next level of usage;[2] (iii) a significant proportion of the poor do not have access to electricity, including a third of households in the poorest 20 percent, and a quarter of rural households. Furthermore, the increase in household income resulting from the expanded coverage of the *Bono* to older children in households in extreme poverty may offset additional electricity costs for some households. The country's low access rates to electricity underscores the importance of

[1] In Honduras, there is no data source reporting both income level and electricity consumption. There is also no recent data set measuring the proportion of household spending allocated to electricity in poor households. These data constraints limit the extent to which analysis can be done directly linking electricity consumption and poverty. Instead, the analysis relies on the observation that poorer households tend to have lower demand for electricity.

[2] Subsidies have been lowered for lower usage rates. The first 100 kWh/month will still receive a subsidy of 30 percent (down from 55 percent) and usage of 100-300 kWh/month will be subsidized by 2 percent (down from 20 percent).

improving the fiscal situation of ENEE so as to create fiscal space to continue expanding electricity coverage. The ongoing restructuring of the ENEE, in part supported by the second operation of this DPF, is also expected to lead to increases in the company's technical and managerial capacity—an important step towards addressing the high public costs associated with this sector. Overall, these measures are expected to advance the financial sustainability of the power sector, creating space to improve access to electricity for the poor over the medium-term.

The expansion of the CCT program to include secondary school enrollment and the increased coverage of the extreme poor in the most vulnerable municipalities are expected to be pro-poor. An earlier program impact evaluation found that the program *Bono Vida Mejor* reduced extreme poverty among beneficiaries while increasing primary school attendance and medical visits. Expanding coverage to encourage secondary school enrollment (7th-9th grade) is well-targeted to address a fundamental challenge facing the future of Honduran growth: the country's exceptionally high dropout rate at the end of 6^{th} grade which ensures a continued low stock of skilled labor in the economy. At the same time, steps being taken to increase the coverage of the program among the target municipalities will result in improved access to public transfers and services for the poorest and most vulnerable regions in a fiscally responsible manner. In line with the analysis of the SCD, these measures aim to disrupt the cycles of poverty, high violence and high out-migration in the municipalities where these factors are most prominent.

While not expected to directly impact poverty, the publication of the country's socioeconomic data, particularly the release of microdata, is expected to yield improvements in public policy design and contribute to increased transparency and better targeting of public spending over the medium-and long-term. The SCD for Honduras identified weak public policy design as a challenge in Honduras, an issue exacerbated by the lack of access to socioeconomic data—a factor which limits the research and understanding of poverty and its evolution in Honduras. To address this gap in knowledge and encourage more analysis and facilitate policy evaluations, prior action 6 will support the publication of the decennial census conducted in 2013, as well as tabulations from the more frequent household survey used to measure poverty. The creation of a Technical Committee tasked with developing a multidimensional poverty index is also expected to increase capacity, lead to data quality improvements, and, most importantly, foster a climate of open dialogue about dimensions of poverty and data. As trust in the public sector is low in Honduras by international standards, this open process as well as the release of the country's socioeconomic data sources may be significant steps forward in increasing public trust in institutions.

Prior actions 7 and 8 are not expected to have a significant effect on poverty in the short-term; however, improving competition in Honduras and facilitating trade are expected to lead to improved job creation over the medium and long-term. They may also contribute to increasing equality of opportunity by eliminating barriers to fair competition that often help protect incumbent firms, thus allowing smaller and younger firms to compete. Moreover effective competition boosts productivity, generating increased labor demand leading to more jobs and/or higher labor earnings. As such, removing the constraints and barriers to business establishment and growth so that the private sector can contribute more to economic growth and job creation will likely translate to poverty reduction.

Environmental Aspects

The majority of the prior actions supported under the proposed DPF are not likely to have significant effects on the environment, forests or other natural resources. The two pillars of this DPF, *Strengthening Institutional Arrangements to Support Fiscal Sustainability* and *Enhancing the Framework to Promote Competitiveness*, are primarily administrative in nature and thus, unlikely to have direct effects on the environment.

a. Strengthening fiscal and financial management through prior actions 1, 3 and 4 is expected to lead to more efficient use of public resources, particularly through enhanced budgeting. These measures will not in themselves reduce spending, but simply facilitate better planning and budgeting. While this could result in cost-cutting measures with implications for public procurement, it is expected that the environmental impact of these actions will be negligible.
b. Prior action 6, the online publication of socio-economic data, is also not expected to have direct environmental impacts.
c. Actions under the second pillar, prior actions 7 and 8 are not expected to have significant direct effects on the environment, forests or other natural resources. The supported actions are focused on creating the appropriate legal and institutional context to support competitive practices; which are aligned with the country's environmental laws.

Reducing electricity subsidies through prior action 2 could have unknown environmental implications. The reform is likely to incentivize increased energy efficiency among consumers, thus contributing to better utilization of energy resources, which would have a positive impact on the environment. This is in line with the country's fiscal sustainability and climate change objectives. However, in the short-term, the increase in electricity tariffs may also lead, is some areas, to fuel substitution to cheaper traditional fuel, in particular firewood, thus contributing to higher indoor and outdoor pollution and further deforestation. As only 17 percent of Honduran households rely on electricity for cooking, and three-quarters of these are not living in poverty, the reduction in subsidies should not imply a significant shift to wood from electricity.[3] For similar reasons, and due to the country's moderate climate, it is not expected that increased electricity tariffs would lead to significant increases in demand for firewood for heating purposes. Furthermore, the impact of this cost increase is likely to be mitigated by the design of the reform, whereby electricity remains directly subsidized for households that use less than 75 kWh/month, i.e. the poorest consumers and those who are the most likely to switch to firewood.

At the same time, measures aimed at increasing the coverage of the *Bono Vida Mejor* and the prioritization of the Platform *Vida Mejor* under prior action 5 can serve to further mitigate the environmental impact of prior action 2. The expansion of the *Bono* to cover more children will have the result of increasing the household income of recipient families in extreme poverty. For those with access to electricity and who use more than 75 kWh per hour, this additional income can offset some of the increase in electric costs. Importantly, the Platform

[3] Because of widespread poverty, 56 percent of Honduran households used firewood as their primary cooking fuel in 2013, including a majority of rural households, with another 25 percent using propane gas. It is expected that higher income households would be more likely to switch to propane than to firewood.

Vida Mejor, which includes providing clean and more efficient cooking stoves to recipient households, may help reduce pollution and the demand for firewood.

VIII. Contact point

World Bank
Contact: Marco Antonio Hernandez Ore
Title: Senior Economist
Tel: (202) 473-6802
Email: marcohernandez@worldbank.org

Borrower
Contact: Rocio Tabora
Title: Presidential Director for Planning, Budgeting and Public Investment and in charge of Vice Ministry of Credit and Public Investment at the Ministry of Finance
Tel: (504)2237 4537
Email: rtabora@sefin.gob.hn

IX. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop