PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: 100939

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	October 14, 2015
Estimated Date of Appraisal	October 30, 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. Key development issues and rationale for Bank involvement

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$1.25 per day, the second highest rate in the region. 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 LAC has moved towards becoming a middle class region, Honduras' middle class has not grown over the past decade and remains one of the smallest in the region. During 2003 and 2007, when real GDP grew by 6 percent on average, new job opportunities led to a reduction in both poverty and extreme poverty. 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. By 2013 poverty rates had returned to the levels seen in 2001.

The country's high poverty rates are to a large extent the result of low and volatile per capita income levels. Honduras per capita GDP is the third lowest in LAC. This is the result of relatively sustained 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 (LMIC) group (3.1 percent). Moreover, growth has been also 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 LMIC.

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 there were over 90 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 about 18 percent of GDP in remittances, the highest rate in Central America. Remittances have been indeed an important source of poverty reduction and income for the population. But remittances also affected labor supply dynamics (through high reservation wages); and impacted the real effective exchange rate. Moreover, because the shortcomings in the investment climate, remittances funded imports and construction, and not productive business ventures that could create jobs.

But there are several other elements that need to be taken into account to understand Honduras' low per capita income and high poverty levels. For example, there are different dimensions of governance weaknesses that affect the country's economic performance including the quality of the regulatory framework which affects the ability of firms to compete and of new firms to enter existing markets, or 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 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 (HIPC) initiative, which cut the public external debt stock by half in 2005-2007, debt accumulated rapidly following the crisis, and currently the Government is spending a higher share of its revenues to service debt payments than it had before the debt relief. An examination of the drivers of poverty in Honduras reveals high sensitivity of poverty to economic shocks and fiscal instability.

The Honduran 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 been reaching internationally and 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 imbalances. 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 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.

The proposed operation supports the administration's efforts to manage the fiscal situation and accelerate growth. In order to advance the framework to promote the sustainability of public finances, the proposed Development Policy Financing (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 the framework to promote competitiveness by (i) improving the regulatory framework to foster competition; and (ii) improving trade facilitation. Implicitly, most of the prior actions and triggers in the proposed DPF aim to address weaknesses in different dimensions of governance.

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 in 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.

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 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.

II. Proposed Objective(s)

The Program Development Objectives of the Development Policy Financing (DPF) are to support the Government's efforts in (i) strengthening institutional arrangements to support fiscal sustainability; and (ii) enhancing the regulatory framework to promote competitiveness.

III. Preliminary Description

The proposed first credit 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 forthcoming World Bank Group's Country Partnership Framework.

IV. 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 Annex 4) suggests an overall positive direct effect on poverty. While some cost-cutting measures may result in increased household spending or changes in household income (through increases in electricity costs or the expansion of the coverage of social transfers), 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.

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. An assessment of the expected environmental impacts of the reforms will be provided in the program document. 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. Reducing electricity subsidies could have unintended environmental implications. Over the medium and long-term, the reform is likely to incentivize increased energy efficiency among consumers, thus contributing to better utilization of energy resources, in line with the country's fiscal sustainability and climate change objectives. However, in the short-term, the increase in electricity tariffs may lead 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. For similar reasons, and due to its 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* can serve to further mitigate the environmental impact of the reduction in electricity subsidies. Importantly, the Platform Vida Mejor, which includes providing clean and more efficient cooking stoves to recipient households, may help reduce pollution and the demand for firewood.

V. Tentative financing

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

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