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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY FINANCING

IN THE AMOUNT OF US\$50 MILLION

TO

THE REPUBLIC OF HONDURAS

FOR THE

FIRST FISCAL SUSTAINABILITY AND ENHANCED COMPETITIVENESS
DEVELOPMENT POLICY FINANCING

November 13, 2015

Macroeconomics and Fiscal Policy Management Global Practice
Poverty and Equity Global Practice
Central America Country Management Unit
Latin America and the Caribbean Region

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**REPUBLIC OF HONDURAS
GOVERNMENT FISCAL YEAR**

January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange rate effective as of November 12, 2015)

Currency Unit
HNL 22.2 =US\$ 1.00

ABBREVIATIONS AND ACRONYMS

CCT	Conditional Cash Transfers
CEDLAS	Center for Distributive, Labor and Social Studies
CREE	Electricity Regulatory Agency
DeMPA	Debt Management Performance Assessment Tool
DNA	Diagnostic for National Action
DPC	Development Policy Credit
DPF	Development Policy Financing
ENEE	Honduras' Electricity Company
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HONDUTEL	Honduras' Telecommunications Company
IDA	International Development Association
IDB	Inter-American Development Bank
IHSS	Honduran Institute for Social Security
IMF	International Monetary Fund
INE	National Statistics Institute
LAC	Latin America and the Caribbean
MTFF	Medium-Term Fiscal Framework
PPP	Public-Private Partnerships
RUP	Single Registry of Participants
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
SEDIS	Secretariat of Social Inclusion and Development
SEDLAC	Socio-Economic Database for Latin America and the Caribbean
SEFIN	Secretariat of Finance
SIAFI-GES	Integrated Financial Management System
SOE	State-Owned Enterprise
TFA	Trade Facilitation Agreement
US	United States
WTO	World Trade Organization

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REPUBLIC OF HONDURAS
FIRST FISCAL SUSTAINABILITY AND ENHANCED COMPETITIVENESS
DEVELOPMENT POLICY FINANCING

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**SUMMARY OF PROPOSED FINANCING AND PROGRAM
REPUBLIC OF HONDURAS
FIRST FISCAL SUSTAINABILITY AND ENHANCED COMPETITIVENESS
DEVELOPMENT POLICY FINANCING**

Borrower	Republic of Honduras
Implementation Agency	Secretariat of Finance
Financing Data	<i>IDA Credit:</i> US\$50 million <i>Terms:</i> Single currency IDA credit with a final maturity of 25 years, including a grace period of 5 years.
Operation Type	First Programmatic Development Policy Financing in a series of two Single Tranche Operations
Pillars of the Operation and Program Development Objective(s)	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.
Result Indicators	<p>The following key outcomes are expected to be achieved by end-2017.</p> <p><i>Strengthening Institutional Arrangements to Support Fiscal Sustainability</i></p> <ul style="list-style-type: none"> • The deviation of actual from projected recurrent expenditure as specified in the medium-term fiscal framework is less than 10 percent in 2016 (against 2015 MTFF) and 2017 (against 2016 MTFF). • ENEE financial deficit is reduced by at least 60 percent in nominal Lempiras relative to its level in 2014 (5,204 million). • Share of public debt issuances that are conducted using competitive auction mechanisms: Baseline 2014: 42 percent; Target 2017: 85 percent • Share of the public sector workforce that has been evaluated by an institutional functional review: Baseline 2014: 0 percent; Target 2017: 50 percent • The number of children in extreme poor households attending 7th to 9th grade that receive cash transfers from the <i>Bono Vida Mejor</i> has increased by at least 60 percent relative to the number in 2015 (78,739); and at least 49 percent of the recipients are boys (in 2015, 48 percent were boys). • Number of years for which the EPHPM microdata (2001-2015) used to calculate official poverty statistics have been made available through INE's website or on Redatam: Baseline 2014: 0; Target 2017: 14 <p><i>Enhancing the Regulatory Framework to Promote Competitiveness</i></p> <ul style="list-style-type: none"> • Number of legal counsels trained to provide advice on a leniency application: Baseline 2014: 0; Target 2017: 30 • Number of days to start a business: Baseline 2014: 14; Target 2017: 10 • Number of days to export and import: Export: Baseline 2015: 12; Target 2017: 11; Import: Baseline 2015: 16; Target 2017: 14
Overall Risk Rating	Substantial
Climate and disaster risks	<i>Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)?</i> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
Operation ID	P155920

**PROGRAM DOCUMENT FOR A
FIRST FISCAL SUSTAINABILITY AND ENHANCED COMPETITIVENESS
DEVELOPMENT POLICY FINANCING
TO THE REPUBLIC OF HONDURAS**

I. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed first credit in a programmatic series of two Development Policy Financing (DPF) operations aims to support Honduras’ efforts to strengthen institutional arrangements to support fiscal sustainability and enhance competitiveness.** The proposed series has been informed by the recently concluded Systematic Country Diagnostic (SCD), *Honduras: Unlocking Economic Potential for Greater Opportunities*. It is well aligned with the Government of Honduras’ development plan (*Plan de Todos para una Vida Mejor*), and with the three pillars of the 2016-2019 World Bank Group’s Country Partnership Framework: “Fostering Inclusion”; “Strengthening Conditions for Growth”; and “Reducing Vulnerabilities”. The proposed amount for the first operation in this DPF series is US\$50 million.

2. **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.

3. **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 of about US\$2,200 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.

4. **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.

5. 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.

6. 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.

7. **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 competitiveness-enhancing structural reforms.

8. **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.

Figure 1: Poverty in Honduras is high and persistent
(Poverty headcount rates, US\$4 per day)

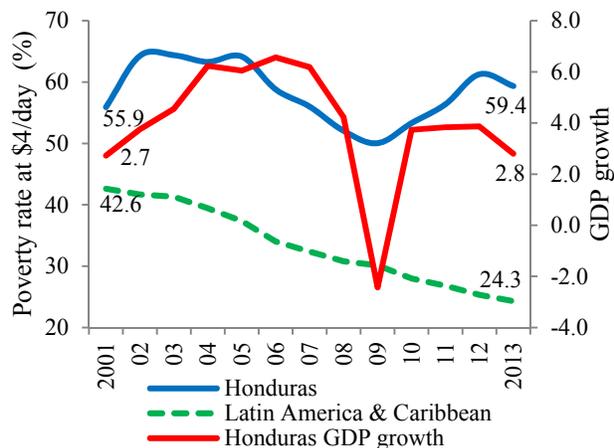
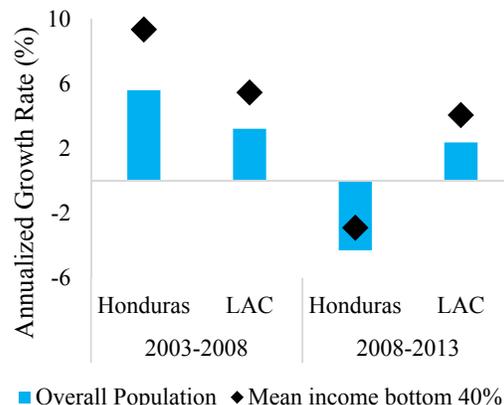


Figure 2: Growth was broadly shared during 2003-2008, but not during 2008-2013
(Income growth of the poorest 40 percent and average income growth)



Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank). The \$4 per day poverty rates are based on 2005 purchasing power parity. LAC income growth of the poorest 40 percent and mean income is based on an unweighted average of income growth in 17 countries.

II. MACROECONOMIC POLICY FRAMEWORK

RECENT ECONOMIC DEVELOPMENTS

9. **Honduras' growth performance has strengthened since 2014 supported by a reform program and aided by more favorable external conditions.** Real GDP growth accelerated from 2.8 percent in 2013 to 3.1 percent in 2014 and to 3.6 percent in the first half of 2015. Growth has been supported by improved terms of trade, the ongoing recovery of the United States (US) that is driving higher remittances inflows and export demand, and improved investor confidence. While growth has not reached the pre-crisis rates (5.9 percent between 2003 and 2007) or those seen in post-crisis recovery periods (3.9 percent in 2010-2012), a moderate recovery is starting to take hold. The economy suffered a number of shocks during 2012-2013, including: (i) weaker trade partners' growth; (ii) a fall in coffee production—the country's main export—due to the rust leaf disease which affected over 25 percent of the cultivated area, coupled with lower coffee prices; and (iii) a contraction in investment due to political uncertainty in a context of national elections and a deteriorating fiscal outlook.

10. **Domestic demand has supported growth in 2014 and in the first half of 2015.** Private investment, which registered a negative growth rate of 4.7 percent in 2013, began to recover in 2014 and the first half of 2015. The growth rate of private consumption remained positive at an average of 3.2 percent during 2013-2014. Consumption growth has been fueled by remittances—around 80 percent of which go to consumption—and the expansion of consumer credit. From the

sectoral side, services grew strongly over the past 18 months – at around 4.8 percent. Agriculture also supported the economy through the recovery of the coffee industry, which employs 10 percent of the Honduran labor force. The manufacturing sector, driven by the product-assembly “maquila” industry, grew by 1.5 percent in 2014, supported by rising demand from the US and has accelerated further to 3.1 percent in the first half of 2015.

11. **The current account balance improved in 2014 and was financed mostly by foreign direct investment (FDI) inflows.** The current account deficit fell to 7.4 percent of GDP in 2014 and is projected to fall further to 6 percent by end-2015, supported by a reduction in imports, strong remittance inflows, and a moderate recovery in exports (Table 1, Table 2). Imports fell in the context of lower oil prices and remittances continued to grow, reaching 18 percent of GDP in 2014 (US\$3.35 billion), the highest level as percent of GDP among Central American countries. The improved external balance led to the accumulation of gross international reserves, which increased from US\$3.1 billion by the end of 2013 to US\$3.7 billion as of August 2015 (or 4.5 months of imports). The current account deficit has been mainly financed by FDI, which accounts for nearly 80 percent of the current account deficit financing.¹

12. **Monetary and exchange rate policies supported economic recovery.** The inflation rate dropped to 5.8 percent in December 2014 and further to 3 percent (year on year) in August 2015, the lowest level since 2009, amid record low oil prices and favorable seasonal factors, and despite the increase in the Value Added Tax (VAT) rate. In response to lower inflation and to cushion the impact of fiscal consolidation on growth, the Central Bank reduced the policy rate by 0.75 percentage points during 2015 from 7 percent to 6.25 percent. In addition, a more flexible exchange rate led to a 2.4 percent nominal depreciation of the Lempira during January-August 2015. The gradual depreciation of the exchange rate is in line with the economic fundamentals.

13. **The Honduran financial sector is generally sound and resilient, though the recent liquidation of *Banco Continental* increased financial sector risks.** The banking sector is well capitalized and profitable, but lacks depth. In 2015, the growth of deposits and credit to the private sector has increased moderately, by 5.8 percent and 3.7 percent, respectively. All financial institutions exceed the minimum capital-adequacy ratio. Bank deposits have held roughly constant at around 45 percent of GDP in 2015. Non-performing loans have declined from 5.1 percent in December 2009 to 3 percent in April 2015, and the share of foreign exchange denominated lending remained stable at around 30 percent of the credit portfolio. The forced liquidation in October 2015 of *Banco Continental*, Honduras’ eighth largest bank with 3.2 percent of total banking sector assets, increased risks to financial sector stability. The authorities have been undertaking an orderly resolution of the bank to limit potential contagion and spillover effects, with support from the IMF and the World Bank (Box 1).

Box 1: Resolution of Banco Continental

On October 11, 2015 the National Commission of Banks and Securities ordered the closure of Banco Continental, as a result of sanctions issued by the US against its owners and the bank. Banco Continental, its

¹ Transport, storage and telecommunications sector was the largest recipient of FDI flows in 2014 (31.6 percent), followed by services (17.4 percent), goods for processing (15.6 percent); manufacturing (14.7 percent), commerce: (9.5 percent), and other sectors (11.2 percent).

owners, and the holding company of the conglomerate have been designated by the US Treasury under the Kingpin Act, which targets drug traffickers and their assets. US persons are prohibited from engaging in any transactions with designated persons, and must block any property in their possession or under their control in which they have an interest. The US Treasury froze the bank's foreign assets, which decreased its capital adequacy ratio from 11.6 percent to 5.2 percent, forcing the authorities to liquidate it. Using the established deposit insurance fund, depositors are being paid up to 208,000 lempiras (US\$9,400), the threshold legally established by this fund.

14. The fiscal position has improved supported by a comprehensive fiscal consolidation program. Since December 2013, the authorities have been implementing comprehensive reforms to boost revenues, reduce expenditures, and improve key dimensions of fiscal management (Box 2). As a result, the deficit of the combined public sector was brought down by 3.3 percentage points of GDP in one year, from 7.6 percent of GDP in 2013 (the highest in the last decade) to 4.3 percent in 2014. On the revenue side, the main measure was a tax reform, which helped to boost revenues by 1.4 percentage points of GDP in 2014 relative to the previous year. On the expenditure side, tighter controls over current expenditures, including the wage bill, led to savings equivalent to 1.9 percentage points of GDP in 2014.² In 2015, the authorities further enhanced spending controls (including a hiring freeze of new public sector staff), strengthened the oversight of payroll and procurement systems, and improved the targeting, monitoring, and evaluation of social protection programs to increase the cost-effectiveness of social spending. In addition, reforms of the state-owned Electricity Company (ENEE) and telecommunications company (HONDUTEL) are expected to generate fiscal savings of around 0.25 percent of GDP. As a result, during the first half of 2015 the public sector deficit was further reduced, and the authorities adjusted its public sector deficit target for end-2015 from an initial target of 3.2 percent of GDP (estimated in December 2014) to a target of 2.4 percent (estimated in October 2015). International lenders are responding positively. The yields and maturity for new domestic bonds have been improving since 2014: yields fell from a peak of 10 percent in August 2013 to 6.5 percent in June 2015, closer to the yields of other Central American countries.

Box 2: Overview of Fiscal Consolidation Reforms since December 2013

Tax policy and tax administration: Key tax policy measures include: (i) increase in the value-added tax rate from 12 percent to 15 percent, bringing it slightly above the LAC average of 14 percent; (ii) elimination of selected value-added tax for import and income tax exemptions; (iii) reduction of minimum tax exemption threshold for the income tax; and (iv) increase in the average fuel tax by about US\$0.25 per gallon (except the fuel used in electricity generation). Regarding tax administration, the authorities are reforming the organization structure of the Revenue Authority with technical assistance from the IMF and IDB. Steps taken in this direction include: (i) the strengthening of the Large Taxpayers Unit; and (ii) the modernization of the Revenue Authority's information technology system.

Public debt management: A medium term public debt management framework has been adopted, and the authorities have exchanged short term maturity bonds (due in 2016-18) with new bond carrying longer maturities.

² Current revenues increased from 21.8 percent of GDP in 2013 to 23.4 percent in 2014, of which 17.3 percent of GDP came from tax collection. Current expenditures, which account for around 80 percent of all public spending, decreased from a peak of 24.5 percent of GDP in 2013 to 22.8 percent in 2014, due to a reduction in purchases of goods and services, and transfers.

Power sector: One of the main contributors to the persistent deficit of the public sector is ENEE. In 2013, ENEE's losses were equivalent to 1.8 percent of GDP, the highest in history, explained by its below-cost tariff structure, subsidies, and high technical losses (e.g., arising from poor infrastructure) and non-technical losses (e.g., arising from weak commercial management, theft and fraud). To reduce ENEE's structural deficit, electricity tariffs were increased by 12 percent in October 2014 and further by 9 percent in December 2014. Electricity subsidies were eliminated for those consuming more than 75 kWh per month. A new Electricity Law was adopted in 2014 which (i) defines sector responsibilities under the *Secretaría de Industria y Comercio*; (ii) creates a new Electricity Regulatory Commission (CREE) responsible for defining methodologies for establishing tariffs and technical standards as well as overseeing transparency in bidding processes; (iii) allows private sector participation in transmission and distribution; (iv) establishes an Independent Market Operator to perform dispatch of generation contracts and guarantee supply adequacy; and (v) restructures ENEE into a holding company with subsidiaries for generation, transmission, and distribution in order to improve accountability, cost efficiency, and reduce cross subsidies. In 2015, ENEE's wage bill was reduced by 40 percent, resulting in a 0.25 percent of GDP reduction in ENEE's deficit.

Public financial management: Supported by a Fiscal Emergency Law the Government began a public sector rightsizing. Implemented measures include: (i) nominal wages freeze during 2014 and 2015; and (ii) the cancelation of 60 percent of the unfilled public sector posts available at the end of 2013. As a result, the non-financial public sector wage bill declined by 1.4 percent of GDP in 2014; the full impact of the reform will be seen in the medium-term due to severance payments to the dismissed workers. A public employment census was completed in 2014 and public sector employees are now recorded in a centralized system integrated with the automated payroll system. To enhance the scope of public-private partnerships (PPPs), the authorities have: (i) introduced a PPP Framework Law which creates a fiscal risk unit within the Ministry of Finance; and (ii) repealed the law that allows government guarantees for debt contracted by companies involved in PPP projects. The Government has also implemented measures to enhance procurement mechanisms, including the adoption of an e-Procurement Law and the signing of shared services agreements to eliminate duplicate procurement functions.

State-owned enterprises: The Government adopted a plan to restore the medium-term financial sustainability of HONDUTEL to (i) appoint a new administration in 2014 with a plan to reduce the number of business units by half; (ii) reduce non-essential spending, including a 35 percent reduction in the workforce, limiting overtime hours, reducing outsourcing and decreasing energy consumption; (iii) improve network efficiency conduction and enhance maintenance and monitoring mechanisms; and (iv) build an strategic partnership with a private company to provide bundled services.

Social protection and social security: The Government (i) improved the targeting methodology of the CCT program *Bono Vida Mejor* to focus on the extreme poor; (ii) adopted a *Vida Mejor* strategy to create an umbrella for social programs; and (iii) created a Single Registry of Participants to improve the monitoring and evaluation of social programs. To cushion the impact of fiscal consolidation on the extreme poor, the coverage of the *Vida Mejor* program was expanded from 270,000 families in extreme poverty in 2014 to about 300,000 families in 2015. Social security measures encompass a new Social Protection Law in 2015 to reform the Honduran Institute of Social Security and introduce a universal health and pension coverage plan with basic unemployment protection.

Supportive monetary, exchange rate, and financial sector policies: A multiyear plan was adopted to recapitalize the Central Bank through non-negotiable bonds bearing a positive real interest rate. A short-term liquidity management policy has been implemented by the Central Bank to enhance monetary policy transmission. Regarding the exchange rate regime, the Central Bank is taking advantage of the flexible current exchange rate regime and let the Honduran Lempira depreciate by 5 percent during 2015. Financial sector reforms include: (i) stricter regulations aimed at reducing exposure to currency mismatches by unhedged borrowers, (ii) pension funds investment policies strengthening in order to protect its resources and maintain adequate returns, (iii) an Anti-Money Laundering and Combatting the Financing of Terrorism legislation.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **Honduras' growth outlook is expected to improve over the medium term on the back of domestic demand.** Real GDP growth is projected to increase to 3.5 percent in 2015 and accelerate further to 3.7 percent in 2017. Growth will continue to be driven by consumption, fueled by the sustained increase of remittance inflows, and the share of private investment in GDP is projected to continue to increase (from about 18 percent in 2013 to an average of 19.6 percent during 2014-2017). The share of public investment is expected to decline temporarily in 2014-2015 (from 5.1 percent of GDP in 2013 to 3.3 percent in 2015), before recovering to 4.1 percent in 2017. Going forward, accelerating private investment growth will require further efforts to reduce the cost of doing business and promote foreign investment and access to credit, as well as measures to improve domestic security conditions.

16. **Economic recovery is expected to take hold across sectors.** Agricultural growth would be driven by the recovery in coffee production combined with rising yields for other export crops. Continued growth in manufacturing, driven by the “maquila” industry, would be supported by moderate but steady growth in external demand. Construction is expected to rebound as increasing investor and household confidence spurs a mild recovery in private residential and commercial investment. Services would continue to grow at the pace observed over the last two years. In the services sector, the sale of rights to the 4G band will allow telecoms and internet providers to expand their services. Financial services are also expected to grow over the medium-term, though financial access would remain limited.

17. **The current account deficit is expected to hover around 6 percent of GDP over the projection period.** The current account deficit is projected to fall from 7.4 percent of GDP in 2014 to 6 percent by end-2015, and remain around that level during 2016-2017, despite somewhat less favorable terms of trade. Improved exports, increasing remittances, and a tighter fiscal policy, will help positively, but remittances and the recovery will continue to support imports growth. The ongoing recovery in the US is expected to bolster export revenues and remittance inflows. Coffee exports are expected to increase, as the rust leaf disease that hit the sector now appears to be contained. Lower oil prices are expected to have a positive impact on the trade balance (as observed in the first ten months of 2015). The current account deficit is projected to be financed mainly by FDI and official assistance.

Table 1: Honduras—Key Economic Indicators, 2011-2017

	2011	2012	2013	2014	2015	2016	2017
Real sector	Annual percentage change, unless otherwise indicated						
GDP (nominal, billions of lempiras)	335	361	377	410	445	477	520
Real GDP	3.8	4.1	2.8	3.1	3.4	3.4	3.5
Per Capita GDP (In US\$ Atlas Method)	2,050	2,040	2,120	2,190	-	-	-
Unemployment rate (ILO definition)	4.4	4.4	4.2	-	-	-	-
GDP deflator	7.8	3.6	1.4	5.5	5.1	3.7	3.7
CPI (eop)	5.6	5.4	4.9	5.8	3.7	4.2	4.5
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Expenditure	25.9	26.7	30.6	28.7	28.6	28.5	28.5
Revenues and grants	23.1	22.5	22.9	24.4	26.2	26.4	26.6
Overall balance	-2.8	-4.2	-7.6	-4.3	-2.4	-2.0	-1.9
Balance of Payments	Percent of GDP, unless otherwise indicated						
Current account balance	-8.0	-8.5	-9.5	-7.4	-6.1	-6.1	-6.2
Exports, f.o.b. (annual percentage change)	27.3	4.8	-6.6	3.4	5.1	3.1	3.1
Imports, f.o.b (annual percentage change)	24.9	2.2	-3.7	1.1	8.0	2.3	2.8
Foreign direct investment (millions of US\$)	1,012	851	992	1,120	1,075	1,184	1,068
Gross reserves (months of imports)	3.6	3.3	3.8	4.3	4.7	5.1	5.6
External public debt	18.1	19.7	28.1	28.5	30.3	30.8	31.6
Terms of trade (annual percentage change)	1.5	-1.1	-2.5	3.0	3.9	-2.9	-0.8
Real effective exchange rate (eop, depreciation -)	1.8	-1.7	0.4	3.6	-	-	-
Memorandum items							
GDP nominal in US\$			18,499	19,511	20,192	21,249	22,750
Public sector debt (in percent of GDP)	32.0	34.7	45.7	46.4	47.8	50.1	51.0

Source: Honduran authorities, IMF staff estimates, and World Bank staff estimates.

18. **Inflation is projected to remain within the Central Bank’s target band of 4.75 ± 1 percent.** The headline inflation rate is expected to accelerate towards the end of 2015 from the exceptionally low levels in the first half of the year, as the base effect of lower oil prices will fade and the inflation rate will gradually return to levels observed in the past. Nonetheless, the annual headline inflation rate is projected to decline to 3.7 percent by end-2015 from 5.8 percent a year previously, and stay within the Central Bank’s target band. Monetary policy is expected to continue to anchor inflation expectations, while tighter fiscal policy will also be supportive of continued price stability.

19. **The fiscal deficit of the combined public sector is projected to decline to 2.4 percent in 2015 and to 1.9 percent by end-2017.** This projection is contingent on the success of the ongoing fiscal consolidation program, with efforts to improve tax administration, contain spending, and address the fiscal risks posed by state-owned enterprises. Meanwhile, the adoption of a Fiscal Responsibility and Transparency Law, supported by a medium-term fiscal and debt framework, and enhanced budgetary, payroll and procurement controls, are also expected to yield fiscal savings provided that implementation is sustained.

Table 2: Honduras—Financing Requirements and Sources, 2013-2017 (millions of US\$)

	2013	2014	2015	2016	2017
Financing requirements (US\$)	2,105	1,762	1,603	1,671	1,815
Current account deficit	1,763	1,444	1,241	1,289	1,416
Debt amortizations	342	318	362	382	399
Public debt amortization	70	95	145	172	195
Private debt amortization	272	223	217	210	204
Financing sources (US\$)	2,105	1,763	1,426	1,651	1,750
Capital account flows (net)	133	145	162	162	162
Foreign direct investment	992	1,120	1,075	1,184	1,068
Public sector borrowing (project related)	600	599	482	396	478
Eurobond	1,000	0	0	0	0
Other capital flows (net)	-74	163	-129	75	-5
Change in reserves (+ decrease)	-546	-264	-164	-166	48
Financing gap	0	0	177	20	65
Multilaterals			177	20	65
Residual financing gap			0	0	0

Source: Honduran authorities and IMF staff estimates.

20. **The projected stronger fiscal position will help contain debt growth and reduce the risk of public external debt distress.** A preliminary Debt Sustainability Analysis was carried out by the IMF and the World Bank in November 2015. Honduras' public debt-to-GDP ratio is projected to peak at about 52 percent of GDP in 2018 (up from 46 percent of GDP in 2014) and start falling slowly as fiscal consolidation proceeds and interest payments decline reaching 39 percent of GDP by 2025. The evolution of external debt ratios is projected to follow a similar pattern: external debt ratios are projected to peak at 39 percent of GDP in 2017, from about 38 percent of GDP in 2014 and decline gradually to 34 percent by 2025. A near-term increase in public external debt from 28.5 percent of GDP in 2014 to 31.7 percent in 2018 will be driven by new bond issues in international markets and by loans from multilateral institutions, while the domestic debt stock is projected to remain stable. Interest payments are projected to increase from 3.0 percent in 2015 to 3.5 percent by 2016, in line with the rise in the stock of public debt. The Debt Sustainability Analysis highlights that under a number of alternative scenarios, public debt dynamics in Honduras remain vulnerable to both policy-related and exogenous shocks, especially to those related to lower economic growth and a worsening of the fiscal balance. Overall, the ratios for the present value of public debt and public debt service remain well below their indicative thresholds in the baseline scenario. No alternative scenario leads to breaching the thresholds for the present value of debt. The threshold for the ratio of debt service to revenue is exceeded in only one year (2020) under the most extreme shock—a 30-percent depreciation of the currency—and reflects the amortization of an international sovereign bond issued with a bullet payment. Meanwhile, the ratio of debt service to exports remains well below its threshold under all scenarios. Against this background, the risk of public external debt distress is considered moderate.

Table 3: Honduras—Fiscal Accounts of the Consolidated Public Sector, 2013-2017

	2013	2014	2015	2016	2017
Percentage of GDP, unless otherwise indicated					
Overall balance	-7.6	-4.3	-2.4	-2.0	-1.9
Primary balance	-7.1	-3.8	-1.3	-0.3	-0.1
Total Revenues (and grants)	22.9	24.4	26.2	26.4	26.6
Current Revenues	21.8	23.4	25.3	25.6	25.9
Tax revenues	15.6	17.3	18.3	18.1	18.2
Non-tax revenues	5.6	5.1	5.0	5.3	5.4
Interest Earnings	1.5	1.6	1.4	1.5	1.3
Operating balance of Public enterprises	-0.9	-0.6	0.5	0.7	1.0
Capital revenues	0.4	0.2	0.1	0.2	0.1
Grants	0.8	0.8	0.8	0.7	0.5
Expenditures	30.6	28.7	28.6	28.5	28.5
Current expenditures	24.5	22.8	22.6	22.8	22.7
Wages and salaries	12.8	11.6	11.0	10.8	10.8
Goods and services	4.4	3.7	3.8	3.5	3.6
Interest payments	2.1	2.1	2.5	3.3	3.2
Current transfers	3.5	3.7	3.7	3.5	3.4
Operating losses of the Central Bank	0.5	0.4	0.5	0.5	0.4
Other	1.3	1.2	1.2	1.2	1.2
Capital expenditures	6.4	6.0	5.8	5.7	5.8
Fixed capital formation	5.1	3.9	3.6	3.7	3.8
Capital transfers	1.2	2.1	2.2	2.0	2.0
Net Lending	-0.4	-0.1	0.1	0.0	0.0

Source: Honduran authorities and IMF staff estimates.

21. **Honduras' macroeconomic policy framework is deemed adequate and sustainable over the medium-term, and hence adequate for the purposes of the DPF operation. Nonetheless, the positive macroeconomic outlook is vulnerable to downside risks.** Growth rates are vulnerable to shocks to export prices, the possibility of weaker growth in the US which would reduce exports and remittances, and unexpected global volatility and higher borrowing costs transmitted through financial channels. In addition, the recent investigation into *Banco Continental* is affecting the operations of *Grupo Continental*, one of the largest Honduran conglomerates. In the event that the companies that make up the conglomerate stop operating, there is potential for spillover effects to the real economy.³ The risk presented by the potential erosion of fiscal discipline and commitment to the structural reform agenda, particularly given that the positive domestic outlook hinges on the continued pursuit of fiscal consolidation, is also important. If growth outcomes are lower than projected, this would require even tighter fiscal

³ The conglomerate, established in 1929, consists of more than 50 businesses, with sectoral exposures including banking and insurance, the media, cement, food packing, commercial and residential property, and agriculture exports. The companies reportedly employ around 11,000 people, with another 25,000 indirect employees. Possible sanctions may extend to the companies of the group owned 50 percent or more by the designated persons. To mitigate potential contagion and spillover effects on the real economy, the Honduran authorities have begun seizing the assets of *Grupo Continental* and other assets owned by the owners of the Group, and transferring them to the Honduran Office of Seized Assets which will be temporarily tasked with their custody and management

policy to support debt sustainability. Further decline in oil prices is beneficial for growth and the fiscal accounts since Honduras is a net oil importer. Macroeconomic risks and mitigation measures are further described in Section VI.

IMF Relations

22. **Honduras has agreed on a Stand-By Arrangement/Credit Facility with the IMF.** The IMF-supported program, approved by the IMF Board of Executive Directors in December 2014, is for a total of SDR 129.5 million. It included a 36-month Stand-By Arrangement (SDR 77.7 million) and a 24-month arrangement under the Standby Credit Facility (SDR 51.8 million). These arrangements aim to help the Government of Honduras to preserve macroeconomic stability and implement a broad structural reform agenda. A First Review of the IMF supported program was successfully completed in September 2015. The IMF Executive Board Assessment of the First Review under the Program is presented in Annex 3.

III. THE GOVERNMENT'S PROGRAM

23. **The 2014 Government's strategy, *Plan de Todos para una Vida Mejor*, builds upon the Country Vision 2010-2038 and the National Plan 2010-2022 approved in 2010.**⁴ Following a consultative process and alignment with the Country Vision, the Government's program identifies four high level objectives or pillars: (i) establishment of peace and the reduction of violence; (ii) employment generation through enhanced competitiveness and productivity; (iii) human development, reduction of inequalities, and social protection; and (iv) a transparent and modern state. Furthermore, the Government endorses seven strategic objectives for the next four years: (1) strengthen social protection; (2) promote sustainable economic growth; (3) stabilize the country's macroeconomic situation; (4) bolster infrastructure and logistics; (5) improve the efficiency and trust in public institutions; (6) sponsor public policy for security, peace, and citizen coexistence; and (7) strengthen international relations, exports, and FDI.

IV. THE PROPOSED OPERATION

LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. **The policies supported by the proposed DPF series are linked to the Government's strategy.** The DPF series aims to strengthen institutional arrangements to support fiscal sustainability and enhance competitiveness, which are essential to preserve the social protection system and generate employment opportunities to reduce poverty and promote shared prosperity. The DPF series fits with pillars (ii), (iii) and (iv) of the Government's strategy, described above, and is also aligned with its strategic objectives (1), (2), (3), (5) and (7).

⁴ The long-term objectives of Vision 2038 are: (i) a Honduras without extreme poverty, educated and healthy with consolidated provision of social services; (ii) a developing democracy with security and without violence; (iii) a productive country generating opportunities for dignified employment with macroeconomic and environmental sustainability; and (iv) a modern, transparent, responsible, efficient, and competitive state.

25. **The design of the DPF series builds on lessons learned from previous operations in Honduras.** The experience of previous DPCs, including the Fiscal Sustainability and Enhanced Social Protection DPC (P151803), Fiscal Emergency Recovery DPC (P121220), and First Programmatic Reducing Vulnerabilities for Inclusive Growth DPC (P127331), highlights the need to take into account the country’s implementation capacity while at the same time consolidating positive outcomes of the Government’s reform efforts, specifically on fiscal, public sector management, social sector issues, and the electricity sector. Lessons from previous DPCs also suggest the need for close coordination with other donors. In this regard, the proposed DPF builds on a close coordination with the IMF and IDB as part of a multilateral effort to support the Government’s agenda for fiscal consolidation and enhanced competitiveness. Notably, the reforms in the fiscal, electricity, and social protection sectors supported by this operation complement those being supported under the IMF and IDB programs. Additional lessons learned include the reliance on strong analytical underpinnings.

PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

26. **The Program Development Objective of the DPF series is to support the Government of Honduras in (i) strengthening institutional arrangements to support fiscal sustainability; and (ii) enhancing the regulatory framework to promote competitiveness.** These two policy pillars complement each other. Improved institutional instruments to support fiscal, financial, and electricity sector management will promote macroeconomic stability and increase the fiscal space needed to safeguard social protection programs and avoid a drastic reduction in capital investments. Better targeting of social protection programs will help direct resources to those that need it the most, partially off-setting potential negative effects of the fiscal stabilization program. Finally, improved policies to detect anti-competitive practices, simplify business and trade regulations, and enhance transparency and accessibility of statistics will contribute to advancing the competitiveness agenda to boost productivity to support growth.

Pillar 1: Strengthening institutional arrangements to support fiscal sustainability

27. **This pillar supports actions to advance fiscal stability by improving (i) fiscal and financial management; (ii) energy subsidies and quasi-fiscal deficits; and (iii) the targeting and transparency of social spending.**

Fiscal planning and transparency

<p>Prior Action 1: The Government, through SEFIN, has: (a) approved and published on the Ministry’s website a medium-term macroeconomic and fiscal framework that is consistent with the medium-term debt management strategy; and (b) submitted this framework to Congress for approval.</p>	<p>Trigger 1: A Fiscal Responsibility and Transparency Law is enacted, specifying: (a) fiscal rules; (b) fiscal procedural rules; and (c) surveillance mechanisms.</p>
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28. **Historically, the performance of public finances in Honduras has been highly volatile.** As noted in the SCD, while some of the volatility of fiscal policy outcomes in the country can be explained by external and natural hazard shocks, a large part is due to institutional arrangements and political decisions. Three key aspects stand out: (i) weak

budgetary controls, especially for current expenditures, have led to higher-than-projected deficits and the accumulation of public arrears, which in turn undermine the efficient allocation of resources; (ii) the electoral cycle has been mirrored in the fiscal policy, as higher fiscal deficits have repeatedly preceded presidential and parliamentary elections; and (iii) the lack of a credible medium-term fiscal framework (MTFF) and fiscal responsibility provisions have led to ad hoc fiscal policymaking with limited transparency, accountability, and sustainability.

29. **International experience suggests that fiscal responsibility frameworks have a positive impact on aggregate fiscal discipline, lead to improved allocative efficiency, and promote greater transparency and accountability of public finances.** The establishment of fiscal targets over several years provides a framework for budget formulation, allows the Government to state clearly its fiscal policy, and provides a tool for the legislature and the public to monitor and hold accountable the Government for their implementation.

30. **The development of a MTFF is an important step for Honduras to institutionalize key dimensions of fiscal policy.** The Government prepared the first MTFF in May 2015 and submitted it to Congress in September 2015. This framework will guide the preparation of the 2016 budget and it has been published on the Secretariat of Finance's (SEFIN) website. The macroeconomic framework includes projections over a three-year horizon (current year plus two years) of the following: GDP growth, the balance of payments, the monetary sector, and the fiscal accounts. The fiscal framework presents highly aggregated data on major revenue and spending items. The framework is consistent with the Government's debt strategy and includes a clear fiscal anchor and fiscal policy targets. To institutionalize this process, in September 2015 SEFIN set up two Committees to coordinate the preparation and monitoring of the MTFF, the Steering Committee and a Technical Committee. The Steering Committee is made up of the Directors of Macro-Fiscal Policy, Budget, Public Credit, Public Investment, Legal Affairs, and the Accountant General. The Technical Committee is made up of the staff of these Directorates.

31. **Going forward, the enactment of a fiscal responsibility and transparency framework will help Honduras maintain a prudent fiscal stance over the medium-term.** A well-designed and implemented fiscal responsibility framework can advance fiscal policy credibility and improve transparency and intergenerational efficiency, thereby enhancing investor confidence and promoting growth.⁵ Nonetheless, fiscal frameworks on their own are no panacea. To succeed, they require political commitment, public scrutiny, and continuous adjustments and vigilance. In this regard, the above-mentioned Steering Committee and Technical Committee will elaborate a Fiscal Responsibility and Transparency bill of law which will be supported by the second operation of this DPF series. The new fiscal responsibility legislation will be aligned with the medium-term debt policy that specifies borrowing procedures for local governments and target debt ceilings for SOEs (Prior Action 3) as well as with the amended Organic Budget Law (Trigger 4).

⁵ International evidence suggests that a sound fiscal responsibility framework should contain three key elements: (i) well-defined fiscal rules appropriate for the country's institutional capacity; (ii) fiscal procedural rules that promote transparency and accountability in budgetary planning, execution, and reporting; and (iii) surveillance mechanisms under the authority of an institution independent of the Government to ensure transparency and compliance.

32. **Expected Results.** The implementation of a MTFE consistent with the country’s debt management strategy is expected to increase fiscal responsibility by aligning spending with income and debt level expectations. Procedural rules, clear indicators, corrective and surveillance mechanisms would improve oversight and control of public spending. Access to relevant macroeconomic and fiscal projections is expected to increase responsible spending by providing relevant and timely indicators needed to make well-informed public spending decisions. A results indicator to evaluate these measures is the deviation of actual from projected recurrent expenditure as specified in the MTFE, which is expected to be less than 10 percent in 2016 and 2017, as compared to the MTFEs from 2015 and 2016, respectively.

Energy subsidies and quasi-fiscal deficits

<p>Prior Action 2: The Government’s National Energy Commission has approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.</p>	<p>Trigger 2: (a) A decree restructuring the Electricity Company (ENEE) has been issued; (b) a decree creating an independent National Electricity Dispatch Center has been issued; and (c) the Government approved enabling regulations for the Electricity Regulatory Agency (CREE).</p> <p>Trigger 3: The Government approved and published a new electricity tariff framework that specifies measures to reduce electricity demand during peak hours.</p>
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33. **ENEE is one of the main contributors to Honduras’ persistent deficit of the public sector, which affects growth and competitiveness.** ENEE’s losses reached the equivalent of 1.8 percent of GDP in 2013, the highest in its history, leading to the adoption of reforms in 2014 to help address structural causes of those losses (see Box 2). These reforms contributed to reducing ENEE’s deficit to 1.3 percent of GDP in 2014. Despite the reforms already undertaken, a combination of structural factors continue to lead to losses by ENEE: (i) about 55 percent of the energy matrix is heavily-based on expensive, obsolete, inefficient and polluting thermal units, a share that is among the highest in the region; (ii) poor conditions of the transmission and distribution networks result in high distribution costs and technical losses; (iii) an inadequate cost recovery scheme; (iv) inefficient tariff structure and adjustment mechanisms; (v) deficiencies in the billing and collecting systems, resulting in high commercial losses; and (vi) sub-optimal governance arrangements.

34. **Addressing ENEE’s inadequate cost-recovery scheme is necessary to manage quasi-fiscal deficits.** ENEE’s inefficient tariff structure translates into electricity prices that are not fully aligned with costs. As a result of cross-subsidies, in 2013 residential customers of ENEE consumed 40.7 percent of the electricity sold, but only paid for 31.3 percent of electricity sales. Distortions in electricity prices, combined with high levels of theft and fraud arising from weak enforcement, have resulted in a higher per capita demand of electricity: for the latest year with available data (2012), Honduras’ energy intensity was one the highest in LAC (1.69), twice the

regional average.⁶ To address these challenges, in November 2014 the Government increased the fuel surcharge associated with the electricity tariff by 12 percent. Additionally, the tariff formula was modified to improve cost recovery by better aligning the prices paid by residential consumers with the cost of electricity generation and distribution. This adjustment, which became effective in January 2015, raised the average tariff by an additional 9 percent.

35. **Further strengthening of the governance of ENEE will be supported under the second operation of the DPF series.** The 2014 Electricity Law establishes that ENEE will be restructured with separate subsidiaries for distribution, transmission, and generation. This separation should increase the transparency throughout the value chain and improve the overall governance and efficiency of the company. Once CREE becomes fully operational, a new updated tariff structure with automatic adjustments will be designed and approved to improve cost recovery and establish adequate price signals to final consumers. This new tariff structure will contribute to a better utilization of the energy resources and the country’s fiscal sustainability.

36. **Expected Results.** These actions are expected to improve the financial sustainability of ENEE through a combination of increased cost recovery, a more efficient use of energy, and improved sectoral governance. More specifically, this reform is expected to reduce the fiscal deficit of ENEE by at least 60 percent in nominal Lempiras relative to its level in 2014 (5,204 million).

Public debt management

<p>Prior Action 3: The Government, through SEFIN, has: (a) approved and published on its website a medium-term public debt policy that establishes public debt ceiling recommended targets for state-owned enterprises, and borrowing guidelines for local governments; and (b) approved and published a calendar for debt issuance for 2015 and 2016.</p>	<p>Trigger 4: Amendments to the Organic Budget Law that improve the public debt legal framework are enacted, specifying: (a) borrowing objectives and procedures for contracting public debt, including the issuance of domestic government guarantees, and (b) requiring mandatory reporting to Congress.</p>
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37. **Responsible debt management is critical to ensuring macroeconomic stability and debt sustainability.** The lack of clear fiscal and debt-policy frameworks in Honduras has resulted in persistent deficits, pro-cyclical policies without buffer accumulation, rising debt levels, and a gradual loss of policy credibility. Notably, in 2008, after receiving debt relief from the Multilateral Debt Relief from the Heavily Indebted Poor Countries initiative, the debt-to-GDP ratio had fallen to 25 percent, but by 2014 it had rapidly increased to 46 percent. Rising debt levels are partly due to political factors coupled with an outdated procedural and transparency rules for fiscal and debt management. The 2014 Debt Management Performance Assessment Tool for Honduras identified a series of shortcomings in most areas of debt management. As a follow-up, the Government, supported by a World Bank technical assistance

⁶ The value represents the energy intensity of GDP, and the figures are calculated as the total energy consumption (in thousands of barrels of oil equivalent) for each million dollars of GDP (in constant 2010 prices). Source: http://interwp.cepal.org/sisgen/ConsultaIntegradaFlashProc_HTML.asp

project, prepared a Reform Plan for Debt Management. The key priorities included: (i) strengthening the legal and regulatory framework; (ii) institutionalizing the development of a medium-term debt management strategy and regular evaluation of its implementation; and (iii) strengthening the operational risk management framework. While one of the major shortcomings of the Honduran debt management framework—a lack of a Debt Strategy—was addressed in 2014 supported by the Fiscal Sustainability and Enhanced Social Protection DPC, the reform agenda continues. Over the short-term, refinements to the scope of the Debt Strategy, which is an actionable policy document, and the financing plan, are needed to start developing a domestic debt market. At the same time, the authorities are working on a new Organic Budget Law to provide a robust legal framework for public debt management.

38. The medium-term public debt policy and its related medium-term debt management strategy are critical steps for strengthening the framework for debt management. They will strengthen internal controls over the debt incurred by local governments and SOEs and improve internal debt records by establishing a calendar for debt issuance. An approved and published Public Debt Policy will enhance control and monitoring of the public debt stock thereby increasing the transparency of fiscal policy. In addition, the introduction of numerical debt ceiling targets for SOEs and borrowing guidelines for local governments will bring more discipline to the fiscal framework and increase the political costs of non-compliance. A detailed debt issuance calendar, including the dates of the auctions and the type of instruments offered, will provide market participants with a secure basis for their investment decisions and will lead to further development of the debt market. It is also expected to lead to an increase in the number of competitive auctions, as opposed to the private placements and hence improve transparency of debt management and its cost-efficiency. It would also facilitate the Government's plan of exchanging bonds maturing in 2016-2018 with longer maturities, thereby increasing the overall debt maturity profile.

39. The Government also plans to amend the Organic Budget Law, a reform that will be supported by the second operation. The new Organic Budget Law will include clear borrowing objectives and establishing procedures for contracting public debt, including mandatory reporting to Congress. This will help to mainstream debt policy formulation process, mandatory annual development and approval of the Government's medium-term debt management strategy, regular reporting requirements, management of direct contingent liabilities in the form of loan guarantees, and coordination between SEFIN and the Central Bank of Honduras. The amended Organic Budget Law (Trigger 4) would become a key component of Honduras fiscal responsibility architecture along with the new Fiscal Responsibility Law (Trigger 1) and a medium-term debt policy and strategy (Prior Action 3).

40. Expected Results. Through the improvement of the country's debt management framework and tools, it is expected that Honduras will enhance its fiscal oversight and debt accrual controls. Additionally, the implementation of clear debt guidelines and procedures will facilitate and encourage the use of competitive auctions for debt purchasing. These actions are expected to lead to an increase in the share of debt accrued through competitive auction mechanisms from 42 percent in 2014 to 85 percent in 2017.

Budget controls

Prior Action 4: The Government, through SEFIN has: (a) created a budgeting module in the Integrated Financial Management System (SIAFI-GES) that specifies budget ceilings consistent the with the medium-term macroeconomic and fiscal framework; and (b) submitted to Congress for approval the 2016 Budget Bill of Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>).	Trigger 5: (a) The Congress has enacted the 2016 Budget Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>); and (b) the Government has undertaken, approved and published institutional functional reviews, and approved corresponding staffing strategies for selected ministries following the findings of the institutional functional review.
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41. **Among the institutional factors threatening to undermine Honduras' fiscal performance is its financial management system.** Financial management systems can be powerful fiscal control tools linking information from different functions and systems, such as budget preparation and authorization, payroll and human resource management, treasury, and payment management. Moreover, as a result of improved transparency, they can build public trust in public institutions while increasing accountability over public spending. When controls over expenditures are weak, individual actors (e.g., agencies, ministries) have room to increase expenditures without proper coordination, generating unexpected fiscal imbalances. At the same time, budgetary ceilings have often been modified by Congress to introduce new expenditure items, affecting both the level and composition of public spending while undermining and weakening fiscal controls already in place. In short, the absence of ex-ante credible controls on spending levels and its composition has contributed to the rise of the fiscal deficit and the opacity of spending. Accountability and transparency in the use of public funds would also foster citizen trust in the Government.

42. **In 2014, the Government launched a medium-term strategy, supported by the Improving Public Sector Performance Project (P110050), to control the public sector wage bill beginning with a personnel registry to reduce leakages and ghost positions.** As of December 2014, nearly 202,784 public employees distributed in 88 central government agencies were included in the staff registry. This registry is routinely cross referenced with monthly payment data from the Integrated Financial Management System (SIAFI-GES) and the Integrated Human Resources System, to validate benefit payments and control against ghost workers. Continuing this line of reform, in 2015, the Government created a budgeting module integrating budget ceilings consistent with the medium-term macroeconomic framework into the SIAFI-GES. This type of budgetary control provides the Government with a comprehensive view of the commitments made over time while avoiding the creation of new commitments without enough funding. As a result, it lessens pressure to adjust budget ceilings. These improvements foster credible ex-ante controls over current expenditures, especially public sector salaries which account for a significant share of the budget.

43. **In a context of scarcity of resources and pressing demands, the transparency and prioritization of public expenditure are critical.** Public trust funds, which account for about 15 percent of the 2015 budget, are registered as transfers in the budget rather than being registered individually. To address this, the 2016 budget proposal introduces two articles (Articles 63 & 64) that require the standardization of procedures for trust funds and create a comprehensive registry

of public trust fund transactions to be recorded in the SIAFI-GES. Moreover, the 2016 budget law will mandate SEFIN to send quarterly reports on trust fund transactions to Congress to improve transparency and accountability over the use of funds. A comprehensive accounting of public trust funds would not only enhance accountability over the use of public resources, but also improve the capacity of the public sector to prioritize resources over the medium-term. This is a key area of development in line with national priorities and the Government has confirmed that it will continue in subsequent years. Technical assistance is being provided to set up the necessary systems to encourage and facilitate this process. These measures are expected to be incorporated into the new Organic Budget Law which is being proposed as a trigger for the second operation (Trigger 4).

44. **Beyond the enactment of the 2016 Budget Law in line with the established fiscal framework, the second operation will support the control of the wage bill through streamlining positions within public sector.** As noted in Box 2, this will be achieved by Cabinet approval of a comprehensive wage bill and human resource management strategy in four central government institutions that, together, account for approximately 80 percent of wage bill expenses (including the Health, Education, Infrastructure, and Security Secretariats). Based on the findings of payroll audits, an institutional functional review will be carried out in these five institutions to review the qualifications of staff relative to the profile required for each position so that each organization is better able to achieve its objectives relying on an effective composition of skills among its workforce. These reviews are likely to lead to the streamlining of positions, typically with savings or efficiencies achieved. Therefore, they will be used as inputs to improve the organizational structure of the entities and will feed into the development of performance-based human resource management system.

45. **Expected Results.** Approximately 88 central government institutions will be implementing the budget module in SIAFE-GES consistent with MTFE. This implementation along with the measures included in the 2016 Budget Bill of Law and the institutional functional reviews are expected to improve payroll controls. By 2017, the share of the public sector workforce that has been evaluated by an institutional functional review is expected to increase from 0 percent in 2014 to 50 percent by 2017.

Targeting and transparency of social spending

<p>Prior Action 5: The Government, through SEDIS, has (a) expanded the coverage of the <i>Bono Vida Mejor</i> conditional cash transfer program to children attending 7th to 9th grade of lower secondary education; and (b) approved a methodology to prioritize the coverage of the Platform <i>Vida Mejor</i> in 141 municipalities most affected by poverty, vulnerability, violence and migration.</p>	<p>Trigger 6: The Government has signed at least one contract with a regulated financial institution for the provision of services to more effectively channel payments of the conditional cash transfer program through basic accounts or other forms of electronic payment.</p>
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46. **Launched in 2010, the *Bono Vida Mejor* (formerly known as the *Bono 10,000*) has become the main social assistance program in Honduras, covering almost 20 percent of the population.** This program has already shown positive results: between 2012 and 2013, extreme poverty among beneficiaries fell by 9 percentage points (in a context where it increased

nationwide) while primary school enrollment and visits to health centers for children aged 0-3 both increased. To increase the fiscal sustainability of the program and as part of Fiscal Sustainability and Enhanced Social Protection DPC, the targeting formula of the program was revised in 2014 to restrict eligibility to beneficiary families classified as extreme poor. The proxy means test for the *Platform Vida Mejor* as well as the CCT program is generally carried out using household data collected through the Single Socioeconomic Form (*Ficha Socioeconomica Unica*). To ensure better identification and targeting of the extreme poor, the formula of the proxy-means test was adjusted by changing the variables and weights to predict income-based extreme and moderate poverty more accurately using the latest available household survey data (2013). This resulted in a reduction of coverage from 320,000 to 220,000 households, and in the budget from 0.7 to 0.5 percent of GDP (US\$100 million) as of December 2014.

47. To protect the poor in a fiscally neutral manner, measures are being taken to further expand coverage of excluded extreme poor families and particularly vulnerable groups. To do this, three key areas are being supported through this operation. First, the *Platform Vida Mejor* will prioritize expansion of social programs to cover the extreme poor in 141 municipalities with the highest rates of poverty (estimated at 90.4 percent), vulnerability, violence and high child migration. This prioritization of resources addresses the complexity of poverty in Honduras by providing a comprehensive package of services aimed at breaking the cycles of migration, crime, and poverty. The authorities estimate that the impact of this prioritization is that poverty will fall by 14 percentage points in these 141 municipalities. Second, the Government seeks to provide incentives for more children to participate in the CCT program while reducing the costs of the program. Thus, CCT benefits are now calculated based on the number of children within each family who fulfil the program's conditions, rather than by household.⁷ Finally, the CCT program will target older children in an attempt to address high dropout rates in secondary school. Starting in mid-2015, the CCT Program covers students in lower secondary education (Grades 7-9), in addition to those in primary school. Benefit amounts will be higher for these older children (2,520 Lempiras per year) to reflect their higher opportunity cost and the importance of economic causes in driving the country's high dropout rates. As shown in the SCD, while the country's rate for primary education is comparable to the best performers internationally at 86 percent, the net enrollment rate for secondary school is only 44 percent—the lowest in Central America—with significant dropout rates in lower secondary, especially among boys (19 percent compared to 14 percent for girls).⁸ Moreover, Honduras is the only country in Central America where the majority of youth who dropped out (53 percent) reports economic causes as the driving factor for dropping out. These changes are expected to result in greater coverage of excluded extreme poor families, particularly in priority municipalities, while maintaining the CCT Program's budget at around 0.5 percent of GDP, in line with other CCT programs in LAC.

48. Going forward, the Government plans to partner with at least one regulated financial institution to ensure more regular, transparent, and timely payments to CCT

⁷ Simulations using the current demographic structure of families in the program suggest that the average transfer will be 5,500 Lempiras (US\$225) per year, almost half of current levels.

⁸ Adelman and Szekely (forthcoming) *School dropout: unresolved issues and new challenges for education progress in Central America*. Washington, DC. World Bank.

beneficiaries. Financial inclusion remains a challenge in Honduras, with a majority of the population not using formal financial services: as of 2014, only 21 percent of adults used formal financial services in Honduras, including only 13 percent of those in the bottom 40 percent. In this context, providing regular and predictable payments has been a challenge for the CCT program, reducing its reliability and ability to smooth consumption of beneficiary households. Contracting private financial institutions with presence in different regions of the country will help the program conduct benefit transfers in an efficient and accountable manner. Challenges still remain in two areas: (a) ensuring that the selection of the financial institution is carried out on a competitive basis; and (b) implementing an effective capacity building activity for beneficiaries who will receive the benefits through different forms of electronic payments. Importantly, this action can also increase the beneficiary’s access to financial instruments.

49. **Expected results:** These actions are expected to increase the fiscal sustainability of the Platform *Vida Mejor* while maximizing its expected impact on poverty by targeting coverage for the most vulnerable. In addition, by increasing coverage to older children, the *Bono* aims to address high dropout rates in secondary school, one of Honduras’ most pressing challenges which has implications for its long-term growth potential. Through the combination of prioritized municipalities and the inclusion of older children, it is expected that the number of children living in extreme poverty that are attending 7th to 9th grade receiving CCTs from the *Bono Vida Mejor* will increase by at least 60 percent relative to the number in 2015 (78,739) and at least 49 percent of the recipients will be boys, as compared to 48 percent in 2015. Due to the changes in how the CCT will be allocated, from family level to child level, the CCT budget as a percentage of GDP is not expected to increase despite the increase in coverage.

Transparency and accessibility of census and household survey information

<p>Prior Action 6: INE has: (a) published the full documentation and metadata of the 2013 Population Census; and (b) published the tabulations of the EPHPM and the 2013 Population Census on its website.</p>	<p>Trigger 7: (a) The Government has completed a poverty map and published the map and the underlying poverty headcount data by municipality; (b) SEDIS and INE have signed an agreement to use the poverty maps in the targeting of social programs; and (c) the Government approved and published a quality assessment for the 2015 household survey.</p>
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50. **Limited accessibility of statistical information has hindered the targeting of social spending.** Through the National Statistics Institute (INE), Honduras releases annual poverty estimates based on its national labor force and household survey (*Encuesta Permanente de Hogares de Propósitos Múltiples, EPHPM*). It also conducts the Honduras Demographic and Health Survey (*Encuesta Nacional de Demografía y Salud*) every five years, and conducted a Population Census in 2001 and more recently, a Population Census in 2013. Moreover, Honduras has one of the longest series of comparable household surveys overtime in the region, allowing for tracking of the evolution of crucial development variables such as poverty, inequality and shared prosperity. Despite this stock of data, accessibility to the data has been limited: in particular, scarce documentation is publicly available regarding the quality of the data that is produced, and access to the microdata is infrequently granted. Lack of data access and

dissemination has limited the usefulness of these data in designing, implementing and evaluating the effectiveness of social programs in Honduras.

51. **To enhance transparency with a view to improving the effectiveness of public spending, the Government has provided more access to data and revamped INE's website to increase its usefulness to users.** INE has published the full documentation and metadata of the recently completed 2013 Population Census using internationally-recognized standards (Data Documentation Initiative) and provided access to the microdata and tabulations of the Population Census through Redatam software. INE also published user-friendly tabulations of the Household Surveys and the 2013 Population Census.⁹ These actions are expected to lead to improvements in the targeting of social spending and policies. Furthermore, recognizing that depth of poverty depends on a number of deprivations that affect well-being and to complement its official monetary poverty measurement while building state capacity for poverty measurement, the Government has established a Technical Committee to develop an official Multidimensional Poverty Index.¹⁰ While generally improving information on poverty in Honduras, the development of such an Index will also contribute to a more updated and better informed targeting system of the Platform *Vida Mejor*, and thus to improving the efficiency of public spending more generally. It is expected that the work of the Committee will improve institutional capacity, while creating a transparent process and a national dialogue around poverty measurement.

52. **Good quality data is crucial for the design, implementation and assessment of social assistance and other pro-poor fiscal policies.** Further strengthening of data transparency and quality through new analysis and research will be supported under the second operation to further inform the Government and other stakeholders about the success of different policies in addressing unmet needs. To this end, the Government is expected to undertake and publish a quality assessment of the 2015 household survey, the country's main source of socioeconomic indicators, including poverty, employment and wage statistics. In addition, to address one of the largest data gaps in the country—the lack of geographical data on poverty—the authorities plan to prepare an updated poverty map, and publish the underlying poverty headcount data by municipality. This updated poverty map will be used to improve the targeting of the Platform *Vida Mejor*. With an eye towards fiscally sustainable public spending, greater access to socioeconomic indicators, including the poverty map, will allow for improved targeting of public programs so as to protect the most vulnerable.

53. **Expected Results.** Measures to improve transparency and accessibility of statistical information are expected to help identify, characterize, and monitor poverty and other social welfare indicators more effectively. An indicator representing one of the expected results from these measures is the publication of the microdata of all available household surveys (2001-

⁹ Redatam is an initiative of La Comisión Económica para América Latina (CEPAL) and widely used in LAC which allows for user-generated tabulations from large microdata files.

¹⁰ The Technical Committee is comprised of international and national representatives, including: the Ministry of Coordination, Ministry of Social Development, INE, the Honduran National University, the Central American Technological University, National Convergence Forum, the Social Forum on Foreign Debt and Development of Honduras, the European Union, the IDB, the World Bank, the United Nations Children's Fund, the United Nations Development Program, and the Oxford Poverty and Human Development Initiative.

2015) on INE’s website or through Redatam. In addition, the 2013 Population Census documentation, metadata and results as well as the tabulations of the household surveys in user-friendly format (e.g., CSV files), are expected to be published on INE’s website.

Pillar 2: Enhancing the Regulatory Framework to Promote Competitiveness

54. **This pillar supports actions to enhance the country’s framework to promote competitiveness by (i) improving the regulatory framework to foster competition; and (ii) improve trade facilitation.**

Regulatory framework

<p>Prior Action 7: (a) the Government has adopted the amended Competition Law which creates a Leniency Program that provides incentives for corporations and individuals that report and cooperate in the investigation of cartel practices; and (b) the Competition Authority has issued regulations that detail the procedures for the Competition Authority to implement the Leniency Program.</p>	<p>Trigger 8: The Government has created the electronic platform “<i>MiEmpresaEnLínea</i>” which simplifies regulatory procedures to start and operate a business in Honduras.</p>
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55. **Although Honduras was one of the first countries in Central America to introduce a competition law in 2005, it ranks 83rd out of 144 countries in terms of the “extent of market dominance” in the 2015 Global Competitiveness Report.** This suggests that experts perceive the economy to be dominated by a few business groups, which hampers competition. International evidence suggests that firms tend to be less productive and less competitive abroad when they face weak competition in domestic markets, while consumers are left with higher prices and lower quality products. Although the Honduras Competition Authority (*Comisión para la Defensa y Promoción de la Competencia*) has identified and partially succeeded in removing important constraints to competition in key sectors—for instance, the Competition Authority detected harmful price-fixing agreements (cartels) in the markets for pharmaceuticals and cement—its effectiveness to detect anti-competitive practices is still limited. As highlighted in the SCD, in Honduras, prices and other market variables in key markets are not determined by competitive forces. For example, potential competitors in the agribusiness sector agree on prices, import quantities, and market quotas for some agricultural products through officially endorsed “agreements” (*convenios*). Several professional associations establish binding tariff schedules for all services provided by its members, who then cannot legally exercise their profession outside the association. Moreover, Honduras controls prices in certain service areas where competition is typically viable, such as cargo transport.

56. **An enhanced legal framework and tools would allow the Competition Authority to detect and deter barriers to competition.** In May 2015, Honduras adopted a new Competition Law that creates a Leniency Program to serve as a channel for communications between public and private stakeholders. The Leniency Program allows the Competition Authority to exempt cartel members from sanctions in exchange for information on the cartel. In line with best international practices, the Leniency Program creates a permanent threat that any of its members may reveal the cartel in order to avoid fines. In October 2015, the authorities adopted

implementing regulations for the Competition Law, which introduced the necessary legal provisions to effectively implement the Leniency Program. Going forward, the authorities will undertake a dissemination strategy to inform businesses and their legal counsels of the details of the Leniency Program as well as its advantages. This will be conducted through workshops, publications, individual dialogue and media outreach so that the option of revealing an anticompetitive agreement becomes a credible threat to cartel members, and deters agreements from the outset.

57. Regulatory burdens pose additional challenges to private sector competition. While Honduras has made notable progress in reducing costs and expediting administrative procedures for starting a business, tax payments, and other business activities, the country still lags behind in international rankings. For instance, it ranks 104th in the world in the ease of doing business according to 2015 Doing Business Report. In the past decade reforms have led to an impressive reduction in time spent on different administrative procedures. In 2006, it took more than 60 days to open a business, and according to the 2015 Doing Business, it now takes 14 days; during the same period, the number of days to deal with construction permits was halved from 165 days to 82 days; and time spent to register property also decreased from 35 days to 22 days. Nonetheless, challenges remain. The Doing Business indicators identify areas in which Honduras continues to struggle: weak governance and transparency of companies (174th out of 189 countries); ease of enforcing local commercial contracts (166th); simplification of the administrative burden and cost of paying taxes (153rd); ability to deal with insolvency chapters and secure recovery (140th); cost of launching new enterprises (138th); and time and cost to access electricity (110th).

58. Support to further streamlining the regulatory framework will be provided under the second operation, with a focus on reducing the costs of starting and running a business. Specifically, the second operation will support the creation of the electronic platform “*MiEmpresaEnLínea*” which is expected to facilitate the following common business tasks: (i) carrying out the procedures necessary to start a business, including municipal permits; (ii) acquiring environmental licenses; and (iii) obtaining permits needed for importing and exporting. In the case of the procedures necessary to open and register a business, the platform implements regulatory changes included in a law passed in 2013 simplifying business registration (“*Ley para la Generación de Empleo, Fomento a la Iniciativa Empresarial, Formalización de Negocios y Protección a los Derechos de Inversionistas*” Decree 284-2013). Taken together, these measures are expected to reduce the number of days needed to start a business by streamlining the processing of key documents required to register a business, including the Commerce Registry, the Tax Registry, and Municipal Licenses. The simplification of processes is expected to benefit small businesses, as currently many small businesses seek the services of legal counsel to process these documents.

59. Expected Results. These measures are expected to enhance competition through improved detection and deterrence of anticompetitive practices through leniency applications and other tip-offs, and by helping avoid unnecessary regulatory barriers to competition in new policies and regulations. A results indicator to evaluate these measures is the number of legal counsels that have been trained to provide advice on a leniency program application. This

number is expected to increase from 0 in 2014 to 30 in 2017. Also, the average number of days that it takes to start a business is expected to be reduced from 14 in 2014 to 10 by 2017.

Trade Facilitation

<p>Prior Action 8: The Government has submitted to Congress for approval a Trade Facilitation Agreement with the World Trade Organization.</p>	<p>Trigger 9: (a) Congress has ratified the World Trade Organization’s Trade Facilitation Agreement; and (b) the Government has created an electronic system to process sanitary and phyto-zoo sanitary certifications for selected agricultural products.</p>
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60. **Excessive “red tape” related to document requirements and burdensome customs procedures lead to extra costs and delays for exporters and importers, stifling trade potential.** Trade facilitation relates to the simplification and harmonization of international trade procedures, including import and export procedures. By helping countries reduce costs, trade facilitation can boost trade flows and allow countries to reap greater benefits from international trade. Honduras has adopted a number of reforms that have improved trading across borders, such as: (i) the implementation of a web-based electronic data interchange system for the Center of Export Procedures, the National Agriculture Sanitary Service, and Customs; and (ii) the installation of X-ray machines at the port of Puerto Cortes, the largest port in the country. The data interchange system resulted in a reduction of the time to obtain export certificates (part of the total time to export) from three days to a few minutes because exporters do not have to report separately to the three relevant agencies.

61. **Honduras has moved ahead on acceptance of a Trade Facilitation Agreement (TFA) with the World Trade Organization (WTO).** The negotiations of the TFA were concluded in December 2013, and the Agreement will enter into force once two-thirds of WTO members ratify the TFA. So far, 12 countries have ratified the TFA, including Nicaragua and Belize. The TFA is of utmost importance for promoting regional integration in Central America because it provides a framework for cooperation between customs and other appropriate authorities.

62. **The TFA contains provisions for expediting the movement, release and clearance of goods, including goods in transit.** It also sets out measures for the effective cooperation of customs and other border agencies concerned with trade facilitation and border clearance and compliance. Moreover, the TFA allows countries to identify provisions that they will implement by the time the Agreement enters into force (Category A) as well as provisions that will be implemented during a transitional period (Category B) and after receiving technical assistance (Category C). In July 2014, Honduras notified the WTO of its Category A commitments, including, among others, the creation of new systems to enhance electronic payments, risk management processes, post-clearance audits, border agency cooperation, and the application of international standards.¹¹ Through these measures, Honduras has committed to a number of modern customs procedures that should have substantial positive impacts on clearance times.

¹¹ The full list of Honduras Category A commitments can be found at: https://www.wto.org/english/tratop_e/tradfa_e/tradfa_e.htm#notifications

63. **With the ratification of the TFA, Honduras will have adopted a framework for trade facilitation that identifies reform priorities.** The TFA comprehensively identifies areas or actions needed to facilitate trade. These include: (i) the publication and availability of trade-related information, and procedures for appeal or review; (ii) measures to enhance transparency and impartiality, as well as fees and charges in connection to imports and exports; (iii) the adoption of procedures for electronic payments, adopt or maintain a risk management system for customs control; and (iv) the publication of average release times, and border agency cooperation. One of the provisions requires members to have a national committee to facilitate domestic coordination and implementation of trade facilitation measures. The TFA guides Honduras' reform agenda for trade facilitation. The launching of the Electronic System for Trade in 2013 complies with the requirement to disseminate and facilitate trade procedures. The issuance of regulations for use of electronic forms has the potential to expedite processing times by avoiding paper forms. The forthcoming creation of an electronic system to process certifications and payments of sanitary and phyto-zoo sanitary certifications and health certificates for selected agricultural products is another important step to facilitate trade.

64. **Expected Results.** These measures are expected to enhance trade facilitation through streamlined import and export procedures and the strengthening of trade facilitation institutions. These objectives would be achieved through the ratification and implementation of a TFA with the WTO and the creation of new systems to process trade operations. A results indicator to evaluate these measures is the number of days required to export and import. For exports, this number is expected to decrease from 12 days in 2014 to 11 days by 2017. For imports, it is expected to decrease from 16 days in 2014 to 14 days by 2017. Empirical literature suggests that a reduction of a one-day in transit would significantly reduce trade costs. A study by Hummels and Schaur highlights that reducing one day in transit would be equivalent to 0.6 percent to 2.1 percent of the value of goods exported.¹²

Analytical Underpinnings

65. **The DPF series is underpinned by extensive analytical work** conducted by the World Bank Group, including the 2015 Honduras SCD, the Honduras Economic Diagnostic for National Action (DNA), the Honduras Social Expenditure Review, and the Honduras Debt Management and Performance Assessment, which together with analytical work by other institutions, provided the basis for an ongoing policy dialogue with the Government. Table 5 links the proposed prior actions to specific analytical work.

Table 5: Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
<p>Prior Action 1: The Government, through SEFIN, has: (a) approved and published on the Ministry's website a medium-term macroeconomic and fiscal framework that is consistent with the medium-term debt management strategy; and (b) submitted this framework to Congress.</p>	<ul style="list-style-type: none"> Honduras SCD (2015); provides an overview of trends and drivers of economic growth, inclusion, and sustainability. It defines priority areas for engagement, which include the promotion of fiscal sustainability, and highlights

¹² Hummels, David L., and Georg Schaur. 2013. "Time as a Trade Barrier." *American Economic Review*, 103(7): 2935-59.

Prior Actions	Analytical Underpinnings
<p>Prior Action 2: The Government’s National Energy Commission has approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.</p> <p>Prior Action 3: The Government, through SEFIN, has: (a) approved and published on its website a medium-term public debt policy that establishes public debt ceiling recommended targets for state-owned enterprises, and borrowing guidelines for local governments; and (b) approved and published a calendar for debt issuance for 2015 and 2016.</p> <p>Prior Action 4: The Government, through SEFIN, has: (a) created a budgeting module in the Integrated Financial Management System (SIAFI-GES) that specifies budget ceilings consistent with the medium-term macroeconomic and fiscal framework; and (b) submitted to Congress for approval the 2016 Budget Bill of Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>).</p> <p>Prior Action 5: The Government, through SEDIS, has (a) expanded the coverage of the <i>Bono Vida Mejor</i> conditional cash transfer program to children attending 7th to 9th grade of lower secondary education; and (b) approved a methodology to prioritize the coverage of the Platform <i>Vida Mejor</i> in 141 municipalities most affected by poverty, vulnerability, violence and migration.</p> <p>Prior Action 6: INE has: (a) published the full documentation and metadata of the 2013 Population Census; and (b) published the tabulations of the EPHPM and the 2013 Population Census on its website.</p>	<p>the role of governance as a core driver of development outcomes in Honduras.</p> <ul style="list-style-type: none"> • Honduras Economic DNA “Maintaining Commitment” (2015) analyzes economic developments, and assesses trends and drivers of poverty and shared prosperity. It highlights that an integral fiscal reform strategy would need to combine revenue and spending measures with structural reforms to address structural challenges and raise the efficiency of public spending. • Debt Management and Performance Assessment (2014) and Reform Plan for Debt Management (2014) highlight the role of debt management to advance fiscal stability and provide an action plan that underpins the prior actions. • Honduras Current Account Assessment (2014) analyzes the drivers of the current account deficit, in particular, the linkages between the fiscal deficit and the current account deficit. • Honduras Social Expenditure Review (2015) highlights the importance of strengthening the targeting of social programs to reduce poverty and promote shared prosperity. • Towards an Efficient and Sustainable Energy Sector Policy Note (2013) links issues of power sector management with fiscal sustainability. It identifies challenges in the sector and mitigation measures. • Institutional Models for Poverty Measurement: International Practices and Lessons for Chile (2014), by Alan Fuchs, Peter Siegenthaler and Renos Vakis. This report draws on the main lessons for poverty measurement from countries in LAC. • Multidimensional Poverty Index, Oxford Poverty and Human Development Initiative (2013) provides a methodological framework for this index.
<p>Prior Action 7: (a) the Government has adopted the amended Competition Law which creates a Leniency Program that provides incentives for corporations and individuals that report and cooperate in the investigation of cartel practices; and (b) the Competition Authority has issued regulations that specify procedures for the Competition Authority to implement the Leniency Program.</p> <p>Prior Action 8: The Government has submitted to Congress for approval a Trade Facilitation Agreement with the World Trade Organization.</p>	<ul style="list-style-type: none"> • Honduras SCD (2015) prioritizes the need to enhance competitiveness to generate job opportunities, highlighting the role of the business regulatory framework, trade facilitation, and transparency of regulations. • WBG/OECD Product Market Regulation Indicators 2013-2014 (2015); World Economic Forum’s Global Competitiveness Report (2015) and Honduras: “<i>Promoviendo la Competencia</i>” Policy Note (2013) provide an overview of regulatory challenges that affect competition in Honduras.

LINK TO CPS AND OTHER WORLD BANK GROUP OPERATIONS

66. **The proposed DPF is fully consistent with the Country Partnership Framework for 2016-2019.** The Country Partnership Framework is anchored in the Government's strategy and includes three pillars: (i) reducing vulnerabilities; (ii) fostering inclusion; and (iii) stimulating growth and competitiveness. The proposed DPF series plays an instrumental role in influencing policy measures to support these three pillars.

67. **This DPF series builds on the enhancements of fiscal management supported by previous DPCs prepared in 2014, 2010 and 2011, as well as other World Bank operations.** As noted in Section IV, the DPF series aims to consolidate reforms supported by previous DPCs, particularly in the areas of fiscal management, power sector management, and social protection. Prior actions also complement ongoing activities supported by the Improving Public Sector Performance Project (P110050), which supports the strengthening of procurement and financial management systems and the improvement of human resource management in the public sector. With respect to the power sector, the proposed DPF supplements the recently closed Power Efficiency Enhancement Project (P104034) that sought to improve ENEE's operational and financial performance. In terms of social protection, the proposed DPF seeks to strengthen policy coordination to ensure the greatest possible impact of public expenditures in terms of poverty reduction and shared prosperity in the midst of fiscal controls. The ongoing Social Protection Project (P115592), which is co-financed by the IDB, supports the *Bono Vida Mejor* program, focusing on coverage and institutional functions.

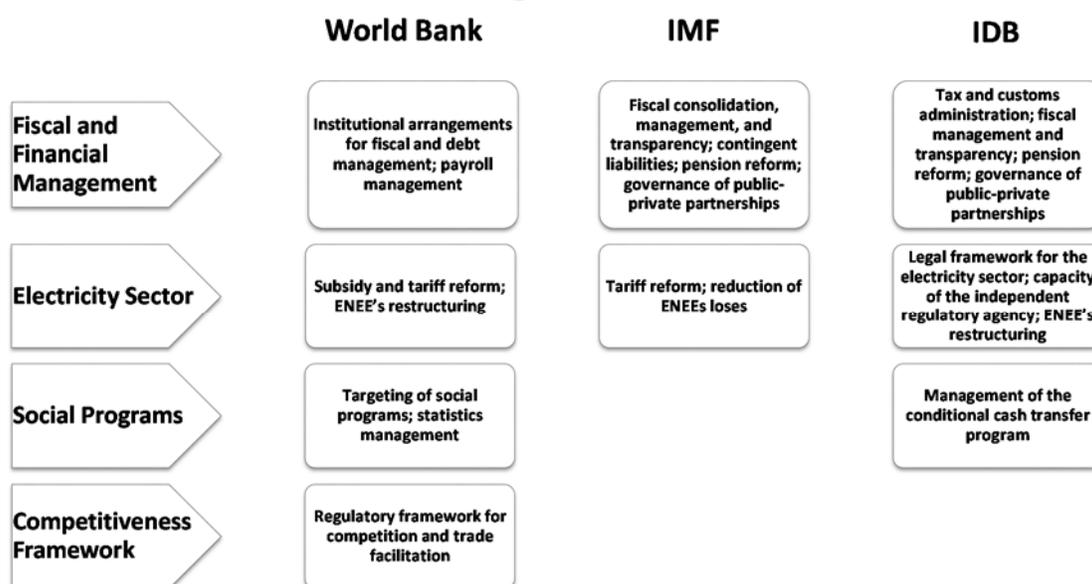
68. **Analytical and advisory activities complement the DPF program on the fiscal, energy, social sectors as well as on debt management, competition and trade facilitation.** The SCD identifies challenges and priority areas to advance fiscal sustainability, growth, and inclusive development for improved living conditions for Hondurans. The 2015 Honduras Economic DNA assesses fiscal policy challenges and links recent macroeconomic developments with trends and drivers of poverty and inequality. A 2014 study of the balance of payments provides a comprehensive assessment of the determinants, sources of finance, and sustainability of Honduras' current account deficit. The 2015 assessment of social spending for Central American countries, including Honduras, analyzes the fiscal sustainability and effectiveness of social programs, providing recommendations for the short- and medium-term.

CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

69. **The design of the proposed DPF was informed by consultation processes among various sectors of Honduran society.** The measures supported by the operation are aligned with the Government's strategy *Plan de Todos para una Vida Mejor*. This document has been subject to consultations with different levels of Government, private sector, and civil society. Measures to strengthen institutional arrangements to support fiscal sustainability (pillar 1) and enhance competitiveness and transparency (pillar 2) are closely aligned with: (i) Honduras' Open Government Action Plan, developed in 2014 through a broad consultation process; (ii) discussions about the need for strategic action to improve fiscal policy management and improve the business climate; and (iii) findings from social auditing processes carried out by civil society organizations.

70. **The proposed program represents a coordinated engagement with development partners.** The proposed DPF series has been prepared in close consultation with the IMF and the IDB as part of a coordinated effort to help the implementation of structural reforms. The First Review of the IMF Stand-By Arrangement/Credit Facility completed in September 2015 noted a strong ownership of the reform program, particular regarding the control of the wage bill and measures to improve the management of ENEE. The IDB is implementing a US\$130 million budget support operation focusing on the power sector, and is preparing a budget support operation focusing on fiscal policy management (including measures to strengthen tax administration, spending controls, financial management, and pension policy). The teams coordinated the design of the policy matrices to support complementary efforts and ease the monitoring and evaluation of the reforms and their results. Figure 3 provides an overview of the reform program supported by the three international financial institutions.

Figure 3: An Overview of the International Financial Institutions-supported Reform Program in Honduras



V. OTHER DESIGN AND APPRAISAL ISSUES

POVERTY AND SOCIAL IMPACT

71. **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 changes in transfers), the majority of actions will not have direct effects on household income in the short-term. Rather, 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.

72. 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.

73. 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.¹³ 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;¹⁴ (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 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.

74. 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

¹³ 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.

¹⁴ 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).

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 6th 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.

75. 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.

76. 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.

Table 4: Likely Poverty and Social Effects of the Prior Actions

Prior Actions	Groups likely to be most affected	Likely Poverty / Distribution / Fiscal Sustainability effects
<i>Pillar 1: Strengthening Institutional Arrangements to Support Fiscal Sustainability</i>		
Prior Action 1: The Government, through SEFIN, has: (a) approved and published on the Ministry’s website a medium-term macroeconomic and fiscal framework that is consistent with the medium-term debt management strategy; and (b) submitted this framework to Congress.		Neutral / Neutral / Positive

Prior Action 2: The Government's National Energy Commission has approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.	Residential electricity consumers with metered access.	Negative / Positive / Positive
Prior Action 3: The Government, through SEFIN, has: (a) approved and published on its website a medium-term public debt policy that establishes public debt ceiling recommended targets for state-owned enterprises, and borrowing guidelines for local governments; and (b) approved and published a calendar for debt issuance for 2015 and 2016.		Neutral / Neutral / Positive
Prior Action 4: The Government, through SEFIN, has: (a) created a budgeting module in the Integrated Financial Management System (SIAFI-GES) that specifies budget ceilings consistent the with the medium-term macroeconomic and fiscal framework; and (b) submitted to Congress for approval the 2016 Budget Bill of Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>).		Neutral / Neutral / Positive
Prior Action 5: The Government, through SEDIS, has (a) expanded the coverage of the <i>Bono Vida Mejor</i> conditional cash transfer program to children attending 7 th to 9 th grade of lower secondary education; and (b) approved a methodology to prioritize the coverage of the Platform <i>Vida Mejor</i> in 141 municipalities most affected by poverty, vulnerability, violence and migration.	Households living in extreme poverty.	Positive / Positive / Positive
Prior Action 6: INE has: (a) published the full documentation and metadata of the 2013 Population Census; and (b) published the tabulations of EPHPM and the 2013 Population Census on its website.		Neutral / Neutral / Neutral
<i>Pillar 2: Enhancing the Framework to Promote Competitiveness</i>		
Prior Action 7: (a) the Government has adopted the amended Competition Law which creates a Leniency Program that provides incentives for corporations and individuals that report and cooperate in the investigation of cartel practices; and (b) the Competition Authority has issued regulations that detail the procedures for the Competition Authority to implement the Leniency Program.		Neutral / Positive / Neutral
Prior Action 8: The Government has submitted to Congress for approval a Trade Facilitation Agreement with the World Trade Organization.		Neutral / Positive / Neutral

ENVIRONMENTAL ASPECTS

77. **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.

78. **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, in 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.¹⁵ 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.

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

PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

80. **According to the latest Public Expenditure and Financial Accountability Report, published in March 2013, public financial management performance in Honduras has improved, but challenges remain.** The authorities continue efforts to strengthen public financial management in key areas, including reducing unreported extra-budgetary funds to an acceptable level; enhancing the transparency in the publication of budgetary information—the

¹⁵ 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.

annual budget proposal and the approved budget, as well as the quarterly budget execution reports are made publicly available in SEFIN's website in a timely manner—and improving the efficiency of human resources controls. However, there are still aspects that require strengthening, as external audit coverage is still low, financial statements of the central government are not fully consolidated, and challenges in the management of budgetary deviations persist. The World Bank is supporting Honduras in its efforts to strengthen public procurement. Based on the above, the fiduciary risk is assessed as Substantial.

81. **Based on the available information, there are some areas of the banking control environment, into which the DPF proceeds will flow, that need to be addressed.** As part of the operation, the World Bank reviewed the latest IMF Safeguards Assessment performed in late 2011 and the audited Financial Statements of the Central Bank of Honduras. An unqualified opinion was issued on the 2013 financial statements, but there is no available evidence on the resolution of the internal control issues. Therefore, a dedicated foreign currency bank account to deposit World Bank credit proceeds would be required. In addition, the Financing Agreement will include a clause indicating the World Bank's right to request an audit of such dedicated account.

82. **The World Bank would make the single credit disbursement to a dedicated account that forms part of the country's official foreign exchange reserves at the Central Bank of Honduras.** The disbursement would be made upon the World Bank's assessment of satisfactory achievement of the agreed prior actions. Disbursement will not be linked to any specific purchases and no procurement requirements would apply. The credit proceeds will be made available to the Government upon credit effectiveness and meeting of the withdrawal conditions. Upon approval of the credit and notification by the Bank of credit effectiveness, the Government will submit a withdrawal application. The proceeds of the credit will be deposited by the International Development Association (IDA) in an account designated by the Government and acceptable to the World Bank at the Central Bank. The Recipient should ensure that upon the deposit of the credit proceeds into the said account, an equivalent amount in local currency is credited into the Treasury current account at the Central Bank. If the proceeds of the credit are used for ineligible purposes (e.g., to finance goods or services on the Bank's standard negative list), the Bank will require the Government to promptly, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled. This condition is reflected in the terms of the Financing Agreement. Within 30 days of remittance of funds by the Bank, the Recipient will provide a confirmation to the Bank that the funds have been received by the treasury account in the Central Bank and that these funds are available for financing budget expenditures. It will also contain a clause for an audit at the World Bank's request of financial transactions from the receipt of the credit proceeds by the Central Bank to the transfer of the local currency equivalent into a treasury account designated for budget expenditures.

MONITORING, EVALUATION AND ACCOUNTABILITY

83. **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, INE, and ENEE. Together with SEFIN, these institutions will collect the necessary data to assess implementation progress and evaluate results.

84. **Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank’s Grievance Redress Service.** The Grievance Redress Service ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank’s independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and the World Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank’s corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. SUMMARY OF RISKS AND MITIGATION

85. **The overall risk of the operation is considered to be substantial.** The most relevant risks that can affect the achievement of the PDOs defined for this operation are political and governance, macroeconomic, institutional capacity for implementation and sustainability, fiduciary, and risks associated with stakeholders.

Risk Categories	Rating
1. Political and governance	Substantial
2. Macroeconomic	Substantial
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Moderate
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary ¹⁶	Substantial
7. Environment and social	Moderate
8. Stakeholders	Substantial
9. Other	Not applicable
Overall risk	Substantial

86. **Political and governance risks are substantial.** These risks are related to the difficult reform agenda that requires broad political support. Political disagreement or legislative gridlock

¹⁶ For the discussion on fiduciary risk, please see section Public Financial Management, Disbursement and Auditing Aspects of the Program Document.

could threaten the pace of the structural reform agenda. The authorities are fully aware of this risk and are utilizing a continuous consultation process and raising awareness on key policy measures, including through the implementation of a communication strategy for more effective outreach from the Government to the broader society. In addition, the authorities have thus far demonstrated a credible commitment to the reform program and there is consensus among the major political parties on the need to maintain macroeconomic stability and advance structural reforms. This consensus has enabled the passage of a number of important legislative reforms. The World Bank Group, in coordination with multilaterals, is conducting a frank and open dialogue with the political leadership at the highest levels, including members of both the executive branch and the legislature, to support consensus on the importance of the reform program.

87. **Macroeconomic risks are substantial.** The risks to the macroeconomic situation stem from external conditions and domestic factors. On the external side, growth rates are vulnerable to terms of trade shocks, a further slowdown in external demand for Honduran exports, and unexpected global volatility and higher borrowing costs transmitted through financial channels. In particular, if global uncertainty translates into weaker demand and employment in the US, this would affect Honduras through lower exports and remittances. External shocks also include natural hazards. Honduras is highly vulnerable to natural hazards with 32 percent of the population (and 33 percent of the country's GDP) located in areas at risk.¹⁷ Domestically, despite an improvement in the fiscal stance, fiscal space remains limited (also due to risks related to fiscal slippages and realization of contingent liabilities), and debt and current account deficit levels remain high, reducing the country's ability to absorb domestic and external shocks. In addition, significant currency mismatches (30 percent of the loans are denominated in foreign currency) pose risks to the stability of the financial sector over the medium-term. The recent liquidation of *Banco Continental* amid a money laundering and drug trafficking investigation has heightened financial sector risks with potential spillover effects to the real economy. The authorities have been undertaking an orderly resolution of the bank to limit potential contagion and spillover effects, with support from the IMF and the World Bank, and are also taking steps to increase the resilience of the financial sector, including reforms to the legal framework. To mitigate macroeconomic risks, the authorities plan to maintain an adequate level of foreign-exchange reserves, with support from the IMF, and budget support from international financial institutions, which would serve as a buffer to mitigate shocks. Furthermore, the policy actions supported in the proposed operation are expected to improve the medium-term fiscal and debt frameworks and address the financial situation of SOEs, which represent a major source of fiscal risks. The authorities are also advancing reforms in the financial sector, including to reduce bank exposure to currency mismatches by unhedged borrowers through higher capital requirements. Furthermore, investment policies are being strengthened so that pension fund resources can be protected while attaining adequate returns.

¹⁷ The SCD highlights that environmental risks could affect the country's macroeconomic stance and delay the pace of reform implementation. Risks from natural hazards are being mitigated by reforms aimed at improving Honduras' capacity to implement a disaster risk management framework at the national and subnational level, and assess fiscal policy instruments to respond to natural hazards. In particular, Honduras has integrated monitoring, forecasting, and decision support systems to improve its hydro-meteorological forecasting accuracy and timeliness of information.

88. **Risks associated with institutional capacity for implementation are substantial.** The Government's multi-sector reform agenda raises the risk that implementation capacity could be stretched thin, and that the pace of reform supported in this operation may be affected. In particular, the effectiveness of the public finance, power sector, social protection, and competitiveness reforms depends on the ability of the administration to apply and enforce new provisions. In this regard, the authorities have taken a series of steps to mitigate those risks, such as reorganization of the administration to improve implementation, and establishment of supervisory arrangements across policy areas, including the creation of an Economic Coordination Cabinet. In addition, reform implementation across all pillars of this operation is being supported by advisory activities and technical assistance from the World Bank Group, IMF, IDB, the European Union, and other development partners. The World Bank Group support focuses on strengthening the management of the power sector, improving public financial management, promoting competition in the private sector, facilitating trade, improving the targeting of social programs, and strengthening monitoring and evaluation systems for poverty reduction.

89. **Environmental risks are moderate.** These risks, as discussed in the Environmental Aspects section above, are of a short-term nature and are related to the reduction in electricity subsidies (prior action 2) which may lead to fuel substitution to cheaper energy sources (e.g. firewood) and thus potentially contributing to higher pollution and deforestation. Mitigation measures include the design of the reform, which maintains subsidies for households using less than 75 kWh/month, including many of the poorest households who are the most likely to switch to firewood. In addition, the Platform *Vida Mejor*, which includes the provision of more efficient cooking stoves to recipient households, may help reduce pollution and the demand for firewood.

90. **Stakeholders' risks are substantial.** These risks relate to the socially-sensitive reform agenda. For example, the energy sector reforms, including the restructuring of ENEE and the introduction of the electricity tariff framework might be resisted by employees and customers. Fiscally neutral adjustments to the *Bono Vida Mejor* will lead to redistribution of resources within the program, which could be opposed by some beneficiaries. The authorities are aware of these risks and are utilizing a consultation process with the stakeholders, including through the implementation of a communication strategy for more effective outreach to the broader society.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions under DPF 1	Indicative Triggers for DPF 2	Results Indicators (by end-2017)
<i>Pillar 1: Strengthening Institutional Arrangements to Support Fiscal Sustainability</i>		
<p>Prior Action 1: The Government, through SEFIN, has: (a) approved and published on the Ministry’s website a medium-term macroeconomic and fiscal framework that is consistent with the medium-term debt management strategy; and (b) submitted this framework to Congress.</p>	<p>Trigger 1: A Fiscal Responsibility and Transparency Law is enacted, specifying: (a) fiscal rules; (b) fiscal procedural rules; and (c) surveillance mechanisms.</p>	<p>The deviation of actual from projected recurrent expenditure as specified in the medium-term fiscal framework is less than 10 percent in 2016 (against 2015 MTFF) and 2017 (against 2016 MTFF).</p>
<p>Prior Action 2: The Government’s National Energy Commission has approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.</p>	<p>Trigger 2: (a) A decree restructuring the Electricity Company ENEE has been issued (b) A decree creating an independent National Electricity Dispatch Center has been issued; and (c) The Government approved enabling regulations for the Electricity Regulatory Agency (CREE).</p> <p>Trigger 3: The Government approved and published a new electricity tariff framework that specifies measures to reduce electricity demand during peak hours.</p>	<p>ENEE’s financial deficit is reduced by at least 60 percent in nominal Lempiras relative to its level in 2014 (5,204 million).</p>
<p>Prior Action 3: The Government, through SEFIN, has: (a) approved and published on its website a medium-term public debt policy that establishes public debt ceiling recommended targets for state-owned enterprises, and borrowing guidelines for local governments; and (b) approved and published a calendar for debt issuance for 2015 and 2016.</p>	<p>Trigger 4: Amendments to the Organic Budget Law that improve the public debt legal framework are enacted, specifying: (a) borrowing objectives and procedures for contracting public debt, including the issuance of domestic government guarantees; and (b) requiring mandatory reporting to Congress.</p>	<p>Share of public debt issuances that are conducted using competitive auction mechanisms: Baseline 2014: 42 percent Target 2017: 85 percent</p>
<p>Prior Action 4: The Government, through SEFIN, has: (a) created a budgeting module in the Integrated Financial Management System (SIAFI-GES) that specifies budget ceilings consistent the with the medium-term macroeconomic and fiscal framework; and (b) submitted to Congress for approval the 2016 Budget Bill of Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>).</p>	<p>Trigger 5: (a) The Congress has enacted the 2016 Budget Law that specifies processes for registering public trust funds in the budget (<i>Fideicomisos</i>); and (b) the Government has undertaken, approved and published institutional functional reviews, and approved corresponding staffing strategies for selected ministries following the findings of the institutional functional review.</p>	<p>Share of the public sector workforce that has been evaluated by an institutional functional review: Baseline 2014: 0 percent Target 2017: 50 percent</p>

Prior Actions under DPF 1	Indicative Triggers for DPF 2	Results Indicators (by end-2017)
<p>Prior Action 5: The Government, through SEDIS, has (a) expanded the coverage of the <i>Bono Vida Mejor</i> conditional cash transfer program to children attending 7th to 9th grade of the lower secondary education; and (b) approved a methodology to prioritize the coverage of the Platform <i>Vida Mejor</i> in 141 municipalities most affected by poverty, vulnerability, violence and migration.</p>	<p>Trigger 6: The Government has signed at least one contract with a regulated financial institution for the provision of services to more effectively channel payments of the conditional cash transfer program through basic accounts or other forms of electronic payment.</p>	<p>The number of children in extreme poor households attending 7th to 9th grade that receive cash transfers from the <i>Bono Vida Mejor</i> has increased by at least 60 percent relative to the number in 2015 (78,739); and at least 49 percent of the recipients are boys (in 2015, 48 percent were boys).</p>
<p>Prior Action 6: INE has: (a) published the full documentation and metadata of the 2013 Population Census; and (b) published the tabulations of the EPHPM and the 2013 Population Census on its website.</p>	<p>Trigger 7: (a) The Government has completed a poverty map and published the map and the underlying poverty headcount data by municipality; (b) SEDIS and INE have signed an agreement to use poverty maps in the targeting of social programs; and (c) the Government approved and published a quality assessment for the 2015 household survey.</p>	<p>Number of years for which the EPHPM microdata (2001-2015) used to calculate official poverty statistics have been made available through INE's website or on Redatam: Baseline 2014: 0 Target 2017: 14</p>
<p><i>Pillar 2: Enhancing the Regulatory Framework to Promote Competitiveness</i></p>		
<p>Prior Action 7: (a) the Government has adopted the amended Competition Law which creates a Leniency Program that provides incentives for corporations and individuals that report and cooperate in the investigation of cartel practices; and (b) the Competition Authority has issued regulations that detail the procedures for the Competition Authority to implement the Leniency Program.</p>	<p>Trigger 8: The Government has created the electronic platform "<i>MiEmpresaEnLínea</i>" which simplifies regulatory procedures to start and operate a business in Honduras.</p>	<p>Number of legal counsels trained to provide advice on a leniency application: Baseline 2014: 0 Target 2017: 30</p> <p>Number of days to start a business: Baseline 2014: 14 Target 2017: 10</p>
<p>Prior Action 8: The Government has submitted to Congress for approval a Trade Facilitation Agreement with the World Trade Organization.</p>	<p>Trigger 9: (a) Congress has ratified the World Trade Organization's Trade Facilitation Agreement; and (b) the Government has created an electronic system to process sanitary and phyto-zoo sanitary certifications for selected agricultural products.</p>	<p>Number of days to export and import: Export: Baseline 2015: 12; Target 2017: 11 Import: Baseline 2015: 16; Target 2017: 14</p>

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Translation of the Letter of Development Policy

GOVERNMENT OF HONDURAS SECRETARIAT OF FINANCE

Tegucigalpa, November 3, 2015

DT-OIP-150-10-2015

Mr.
JIM KIM
President
World Bank
Washington, D.C.

Reference: Honduras: Letter of Development Policy for the First Sustainability and Enhanced Competitiveness Development Policy Financing

Dear Mr. President:

Hereby I affirm the commitment of the Government of Honduras to continue with policies to promote fiscal sustainability and competitiveness as a fundamental part of the economic, social and environmental development of Honduras. President Hernandez's Administration has adopted ambitious policy measures which have set the foundations for inclusive growth and fiscal sustainability. These policies have already shown positive outcomes.

Specifically, the government is working towards macroeconomic stability, fiscal strengthening, providing services to vulnerable groups, and reigniting economic growth so as to fulfill our responsibility to provide services, invest to support economic activity and sustain a social climate conducive for productive activity and improvements for the population. For this purpose, reforms have been introduced to macro fiscal management and the tax system and its management; public expenditure is being targeted to support vulnerable groups; public debt is being reorganized and will be managed in a sustainable manner; the finances of major public companies are being strengthened; transparency has been improved; and the business climate is being strengthened to increase competitiveness in the country.

Macroeconomic context. The policies implemented since the beginning of this administration have strengthened the country's economy: economic growth increased, inflation fell, and the external position was strengthened. To achieve fiscal consolidation, at the end of 2013 the Government implemented an ambitious reform program, including: (i) an increase in the general sales tax (from 12% to 15%); (ii) an increase in the gas and diesel tax by US\$0.25 per gallon of fuel and diesel; (iii) pre-payment of income taxes for persons and companies with an income of more than L10 million (equal to about US\$450,000) per year; (iv) the reduction of transfers for decentralized entities; and (v) the reduction of the electricity subsidy (decreasing the subsidy

eligibility threshold from 150 kWh/month to 75 kWh/month). This program of fiscal consolidation has contributed to economic activity maintaining a steady pace and GDP is forecasted to grow between 3.0 and 3.5 percent by the end of this year. Additionally, inflation has remained low, with an average inter-annual estimate of the Consumer Price Index (CPI) ranging within $\pm 4.75\%$ percentage points for 2015. As a result of the on-going implementation of the economic program, these trends will continue, including expectations of a similar expansion of GDP between 3.0% and 3.5% for 2016, while inflation will range between 4.0% and 5.0% during the coming year. With regards to the Public Sector, it is expected that the strengthening of the consolidated public sector global balance will continue after having fallen by 1.3 percentage points of GDP, with a decline to 2.7% of GDP from the 4.0% recorded in 2014. This resulted from a fall in the central administration deficit on the order of 0.6% of GDP, an increase of 0.2 points of GDP in surplus from social security, public retirement and pension institutions and a reduction in losses from non-financial public companies of 1% of GDP. The 2016 forecast is for additional reductions, reaching 1.7% of GDP by the end of 2016.

These results were generated due to restrictions on expenditures, especially in current expenditures, the restructuring and implementation of financial controls in the pension institutions, as well as the strengthening of state-owned enterprises, in particular the Electricity Company (*Empresa Nacional de Energía Eléctrica*) for which an ambitious set of measures (tariffs adjustment, reduction of consumer arrears, administrative restructuring) was initiated. Likewise, good tax performance has contributed to fiscal strengthening through the collection of taxes equivalent to 16.7% of GDP. The fiscal consolidation also strengthened the external position. Therefore, for 2015, it has been estimated that the balance of payment current account deficit will be 6.5% of GDP and the accrual of international monetary reserves will cover more than 3.5 months of goods and services imports.

The following paragraphs present the goals and priority policy actions the government has taken to strengthen institutional standards and arrangements to support fiscal sustainability and reinforce the framework to promote competitiveness both of which are framed in the 2014-2018 Government Plan which responds to the 2038 Country Vision, approved in January 2010.

Fiscal Sustainability strengthening. To strengthen macro fiscal management, the government has improved legal and fiscal policy instruments so as to facilitate financial planning and assuring greater predictability of public spending; to this end, a medium-term macroeconomic and fiscal framework was approved. This document was published in the Ministry of Finance (SEFIN) Website and was submitted to National Congress as part of the documents supporting the Executive Branch General Revenue and Expenditure Budget Proposal for fiscal year 2016. Additionally, this framework is consistent with the medium-term debt management strategy.

Furthermore, the government through SEFIN approved the medium-term public debt policy, which includes public debt ceiling targets, including those recommended for state owned enterprises. This policy is published in the SEFIN Web Site. Also, a medium-term debt management strategy was approved, which includes a calendar for debt issuance for 2015 and 2016 and a calendar to review debt maturities until 2025, which has also been published in the Web page.

With the aim of reinforcing the Integrated Financial Management System (SIAFI-GES) and having more efficient operations, a budget module was created, which includes budget ceilings that are consistent with the medium-term macroeconomic and fiscal framework. Also, articles establishing the registration process for public trust funds in the Budget are included as part of the general provisions of the 2016 General Income and Expenditure Budget Law; these were sent to Congress for its discussion and approval.

In order to better reflect the cost of supplying electricity to users and diminishing the losses incurred by *Empresa Nacional de Energía Eléctrica* (ENEE), the Government National Energy Commission approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.

Among recent measures taken by the government to improve the public expenditure quality as well as to improve service and focus on vulnerable groups, the government, through the Ministry of Development and Social Inclusion (SEDIS) expanded the conditional cash transfer program *Bono Vida Mejor* to children in the 7th through 9th grade and approved a methodology to prioritize the *Vida Mejor* platform coverage in the 141 municipalities most affected by poverty, vulnerability, violence and migration.

Aimed at supporting a focus on transparency, through the National Statistics Institute (INE), the Government published the full documents and metadata of the 2013 Population and Housing Census, as well as charts and tabulations from the multi-purpose permanent household survey (EPHPM) in the INE Website.

Competitiveness Promotion. To promote competition and identify anti-competitive practices, the government approved the incorporation of a leniency program in the Competition Law that offers incentives for corporations or individuals to inform and cooperate in the investigation of cartel practices (Decree 04- 2015 published on May 23, 2015), as well as regulations that specify procedures that the competition authority must follow to implement the leniency program (published on October 15, 2015).

The Government, as part of its program to enhance competitiveness, submitted the Trade Facilitation Agreement signed in the context of the World Trade Organization to National Congress for its approval and ratification.

Next Steps. The above referred advances are in compliance with our commitment to fiscal sustainability and the promotion of competitiveness, and determine our access to the Development Policy Credit. In the future, the Government of Honduras will prioritize the following actions to assure the advancement and consolidation of this process:

- a. To have, in the first half of 2016, a Fiscal Responsibility and Transparency law that will include numerical fiscal rules and transparent compliance and follow-up procedures.
- b. To have (including the approval of necessary legal frameworks) the business units that make up the new restructured *Empresa Nacional de Energía Eléctrica* in operation, as well as the Electric Energy Regulating Commission (CREE) and the National Center of the Electricity Office; to approve and publish new electricity rates aimed at reducing

- demand during peak hours.
- c. To approve, by the third quarter of 2016, the Organic Budget Law, related to the objectives and procedures to procure public debt and reporting to National Congress in line with best practices.
 - d. For Congress to approve the 2016 Budget Law, which will specify procedures for the budget registration of trust funds.
 - e. To conduct and approve public institutional operational audits and approve corresponding staff strategies for the selected ministries, following-up the findings of the Institutional Operational Review.
 - f. SEDIS will subscribe at least one service delivery contract with one regulated financial institution for efficient payment of conditional cash transfers.
 - g. Complete and publish a poverty map including poverty headcounts by municipality supported by an agreement between SEDIS and INE for the application of the poverty map to the target of social programs. In addition, publish a quality evaluation of the 2015 household survey.
 - h. To put into operation the electronic platform “MiEmpresaEnLínea” in order to simplify the procedures to establish and operate a business in the country, and,
 - i. That the National Congress, during the first half of 2016, ratifies the Trade Facilitation Agreement subscribed in the context of the World Trade Organization, and to have an electronic system to process sanitary and phytosanitary licenses for selected agriculture products.

The World Bank’s support is indispensable to continue in the path of supporting fiscal sustainability, promoting competitiveness and transparency and strengthening the political framework and actions included above, as well as contributing to the achievement of the ambitious objectives established by the Government.

In view of the above, the Government of Honduras requests the approval of the operation of the “First Fiscal Sustainability and Enhanced Competitiveness Development Policy Financing” for the amount of US\$50 million.

Reaffirming the commitment of the Administration of President Hernández with the proposed policy actions proposed in this program, which I endorse,

Wilfredo Cerrato, Rodriguez
Minister of Finance

DT-OIP-150-10-2015

Tegucigalpa, M.D.C.
03 de noviembre de 2015

Señor
JIM KIM
Presidente
Banco Mundial
Washington, D. C.

Referencia: CARTA POLÍTICAS DE DESARROLLO DE SOSTENIBILIDAD FISCAL
Y MEJORA DE LA COMPETITIVIDAD.

Estimado Señor Presidente:

Mediante la presente manifiesto a usted el compromiso del Gobierno de Honduras de continuar con políticas de promoción de la sustentabilidad fiscal y la competitividad como parte esencial de las políticas de desarrollo económico, social y ambiental de Honduras. La Administración del Presidente Hernández ha adoptado medidas de políticas ambiciosas que han sentado las bases para un crecimiento incluyente y la sustentabilidad fiscal. Estas políticas han comenzado a rendir resultados positivos.

En particular, el gobierno busca la estabilidad macroeconómica, el fortalecimiento fiscal, atender a los grupos vulnerables en desventaja y reactivar el crecimiento económico de forma que se atiendan las responsabilidades de prestación de servicios, inversión en apoyo a la actividad económica y mantener el clima social apropiado para el normal desenvolvimiento de la actividad productiva y el desarrollo de la población. Para ello se han introducido reformas a la gestión macrofiscal, al sistema tributario y su gestión, se ha iniciado la racionalización del gasto público apoyando la inversión y la atención de los grupos vulnerables en mayor desventaja, se reordena y manejará de forma sostenible la deuda pública así como se fortalecen las finanzas de las principales empresas públicas, se mejora la transparencia y se fortalece el ambiente de hacer negocios para incrementar la competitividad del país.

Contexto macroeconómico. En función de las políticas emprendidas desde el inicio de la presente administración se ha continuado fortaleciendo la economía del país: aumentó el crecimiento económico, la inflación disminuyó y la posición externa se fortaleció. Para la consolidación fiscal, el Gobierno desde finales de 2013 implementó un ambicioso programa de reformas, entre ellas destacan: (i) incremento del impuesto general sobre ventas (de 12% a 15%); (ii) incremento de US\$0.25 por galón de combustible al impuesto a la gasolina y el diésel; (iii) pago de anticipo de impuesto sobre la renta a personas y empresas con ingresos superiores a L10 millones (equivalente a cerca de US\$450 mil anuales); (iv) reducción de

transferencias a entes descentralizados; y, (v) reducción del subsidio a la electricidad a consumidores (disminución del umbral de subsidio de 150 kWh/mes a 75 kWh/mes). El contexto de consolidación fiscal ha coadyuvado a que la actividad económica se ha venido desempeñando a un ritmo robusto y se proyecta un crecimiento entre 3.0 a 3.5 por ciento anual del PIB para el cierre del presente año. Al mismo tiempo, la inflación se ha mantenido baja, con una estimación interanual, medida por el Índice de Precios al Consumidor (IPC), que se ubicará en un rango de 4.75% \pm un punto porcentual para 2015. Con la continua implementación del programa económico estas tendencias continuarán, esperando una expansión similar del Producto Interno Bruto (PIB) entre 3.0% a 3.5% para 2016, mientras que se anticipa que la inflación se ubicará entre 4.0% a 5.0% en los próximos años. En cuanto al Sector Público, se espera que continúe el fortalecimiento del balance global del sector público consolidado ya que se redujo en 1.3 puntos porcentuales en relación al PIB al bajar a 2.7% en 2015 del 4.0% registrado en 2014. Este resultado se alcanzó en función de una reducción de 0.6 puntos del PIB en el déficit de la administración central, un incremento de 0.2 puntos del PIB en el superávit de las instituciones de seguridad social, jubilación y pensiones públicas y la contracción de 1% del PIB en las pérdidas de las empresas públicas no financieras. Para 2016, se proyecta una reducción adicional y lograr un nivel de 1.7% con respecto al PIB al cierre de 2016.

Estos resultados son producto de la contención del gasto, especialmente el orientado a las erogaciones corrientes, al proceso de reestructuración y control financiero de los institutos de pensiones así como el fortalecimiento de las empresas públicas, especialmente la Empresa Nacional de Energía Eléctrica para la cual se ha iniciado un proceso ambicioso de medidas (ajuste tarifario, reducción de mora entre los abonados, reestructuración administrativa, entre otras). Asimismo, el buen desempeño tributario ha contribuido al fortalecimiento fiscal al lograr una presión tributaria de 16.7% del PIB. La consolidación fiscal también ha apoyado a fortalecer la posición externa. De tal forma, para 2015, se estima que el déficit en cuenta corriente de la balanza de pago se ubicará en 6.5% del PIB y se prevé que la acumulación de reservas monetarias internacionales cubrirán más de 3.5 meses de importaciones de bienes y servicios.

En las siguientes líneas se presentan los objetivos y acciones prioritarias de política que el gobierno ha tomado que fortalecen las normas y arreglos institucionales que apoyan la sostenibilidad fiscal y robustecen el marco para la promoción de la competitividad enmarcados en el Plan de Gobierno 2014-2018 que responde a la Visión de País 2038 aprobada en enero de 2010.

Fortalecimiento de la sostenibilidad fiscal. Para el fortalecimiento de la gestión macrofiscal el gobierno ha mejorado los instrumentos legales y de política fiscal de forma que faciliten la planificación financiera y se asegure mayor predictibilidad; es por ello que se aprobó un marco macroeconómico y fiscal de mediano plazo, este documento se publicó en el sitio Web de la Secretaría de Finanzas y fue presentado al Congreso Nacional como parte de los documentos de apoyo que acompañan a la propuesta del Ejecutivo del Presupuesto

General de Ingresos y Egresos del ejercicio fiscal 2016. Adicionalmente, dicho marco es consistente con la estrategia de gestión de deuda de mediano plazo.

De igual forma, el gobierno a través de la SEFIN aprobó una política de deuda pública de mediano plazo que establece techos de deuda pública incluyendo los recomendados para empresas estatales, esta política está publicada en el sitio Web de la SEFIN. Asimismo, se aprobó una estrategia de gestión de deuda de mediano plazo que incluye un calendario para la emisión de deuda para los años 2015 y 2016 y un calendario para la revisión de los vencimientos de deuda hasta 2025, habiendo sido publicada en su página Web.

Con vista a fortalecer el Sistema de Administración Financiera Integrada (SIAFI-GES) y contar con operaciones más eficientes se creó un módulo de presupuesto que especifica techos presupuestarios que son consistentes con el marco macroeconómico y fiscal de mediano plazo. Además, se envió al Congreso para su discusión y aprobación artículos en donde se estipulan los procesos para el registro de fideicomisos públicos en el presupuesto (Fideicomisos) como parte de las disposiciones generales de la propuesta de la ley del presupuesto general de ingresos y egresos 2016.

Con el fin de reflejar mejor el costo de suministrar electricidad a los usuarios y disminuir las pérdidas incurridas por la Empresa Nacional de Energía Eléctrica (ENEE), la Comisión Nacional de Energía del Gobierno aprobó y publicó una estructura de tarifa de energía que reduce el subsidio de la electricidad para los consumidores residenciales.

Entre las medidas recientes tomadas por el gobierno para mejorar la calidad del gasto público y así atender y focalizar mejor en los grupos vulnerables en desventaja, el gobierno a través de la Secretaría de Desarrollo e Inclusión Social (SEDIS) ha expandido la cobertura del programa de transferencias monetarias condicionadas Bono Vida Mejor hacia niños de 7 a 9 grado y aprobó una metodología para dar prioridad a la cobertura de la plataforma de Mejor Vida en 141 municipios más afectados por la pobreza, vulnerabilidad, violencia y migración.

Con el objetivo de apoyar la focalización y transparencia, el gobierno a través del Instituto Nacional de Estadística (INE) publicó la documentación completa y los metadatos del censo de población y vivienda 2013, así como publicó cuadros de tabulaciones de la encuesta permanente de hogares para propósitos múltiples (EPHPM) y del censo de población de 2013 en el sitio Web del INE.

Promoción de la competitividad. Con el fin de promover la competencia y detectar prácticas anticompetitivas, el gobierno aprobó para incorporarse dentro de la Ley de Competencia un programa de clemencia que proporciona incentivos para corporaciones o individuos que informen y cooperen en la investigación de prácticas de cártel (Decreto 04-2015 publicado el 23 de mayo de 2015) así como regulaciones que especifican procedimientos que la autoridad de competencia debe adherirse para ejecutar el programa de clemencia (publicadas el 15, de octubre de 2015).

El Gobierno como parte de su programa para mejorar la competitividad del país presentó al Congreso Nacional para la ratificación y aprobación el Acuerdo de Facilitación de Comercio suscrito en el contexto de la Organización Mundial del Comercio.

Próximos pasos. Los avances antes descritos determinan el cumplimiento de nuestro compromiso hacia la sostenibilidad fiscal y promoción de la competitividad y así poder acceder al Crédito de Políticas de Desarrollo. Hacia el futuro el Gobierno de Honduras dará prioridad inmediata a las siguientes acciones para asegurar el avance y consolidación del proceso:

- a) Contar, en el primer semestre de 2016, con una Ley de Responsabilidad y Transparencia fiscal que cuente con reglas numéricas fiscales y procedimientos transparentes de cumplimiento y seguimiento.
- b) Tener (con sus respectivos marcos legales aprobados) en operación las unidades de negocio que comprenden la nueva Empresa Nacional de Energía Eléctrica reestructurada así como la Comisión Reguladora de Energía Eléctrica (CREE) y el Centro Nacional de Despacho de Electricidad. Además, aprobar y publicar un nuevo marco de tarifas eléctricas que sea conducente a reducir la demanda durante horas pico.
- c) Aprobar, a más tardar durante el tercer trimestre 2016, reformas a la Ley Orgánica de Presupuesto en relación a los objetivos y procedimientos para la contratación de deuda pública y la remisión de informes al Congreso Nacional en línea con las mejores prácticas.
- d) Que el Congreso apruebe la Ley de Presupuesto de 2016, especificando procedimientos y registro presupuestal de fideicomisos.
- e) Realizar, aprobar y publicar auditorías funcionales institucionales y aprobar las correspondiente estrategias de personal para ministerios seleccionados, siguiendo los hallazgos de la revisión funcional institucional.
- f) La SEDIS suscribirá por lo menos un contrato de entrega de servicios con una institución financiera regulada para el pago eficiente de transferencias monetarias condicionadas.
- g) Completar y publicar un mapa de pobreza junto con el recuento de pobres por municipio, acompañado por un acuerdo entre SEDIS e INE de aplicación del mapa de pobreza para la focalización de programas sociales. Asimismo, publicar una evaluación de calidad de la encuesta de hogares 2015.
- h) Tener en operación la plataforma electrónica "MiEmpresaEnLínea" de forma que se simplifiquen los procedimientos para iniciar y operar un negocio en el país. Y,
- i) Que el Congreso Nacional, para que en el primer semestre 2016, se ratifique el Acuerdo de Facilitación del Comercio suscrito en el contexto de la Organización Mundial del Comercio y que se cuente con un sistema electrónico para tramitar los permisos sanitarios y fitozoosanitarios para productos agrícolas seleccionados.

El apoyo del Banco Mundial es imprescindible para continuar en la senda de apoyo a la sostenibilidad fiscal, la promoción de la competitividad y la transparencia y fortalecer el marco de política y acciones antes señaladas y así coadyuvar al logro de los objetivos estratégicos ambiciosos que el Gobierno se ha trazado.



Gobierno de la
República de Honduras

SECRETARÍA DE FINANZAS

Por todo lo antes expuesto, el Gobierno de Honduras solicita la aprobación de la operación del "Primer Financiamiento de Políticas de Desarrollo de Sostenibilidad Fiscal y Mejora de la Competitividad" por un monto de US\$50 millones.

Reiterando el compromiso de la Administración del Presidente Hernández con las acciones de política propuestas en este programa, me suscribo atentamente


WILFREDO CERRATO RODRIGUEZ
Secretario de Estado



ANNEX 3: IMF RELATIONS ANNEX

IMF Completes First Reviews Under the Stand-By Arrangement and Arrangement Under the Stand-By Credit Facility for Honduras

Press Release No. 15/411

September 11, 2015

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Honduras's performance under an economic program supported by a three-year Stand-By Arrangement (SBA) and a two-year arrangement under the Stand-By Credit Facility (SCF). This blended program was approved on December 3, 2014 in the amount of SDR 129.5 million (then about US\$188.6 million), the equivalent of 100 percent of Honduras' quota in the IMF (see [Press Release No. 14/545](#)). With the completion of the review, the authorities have access to resources in the total amount of SDR 45.325 million (about US\$63.8 million); however the authorities plan to continue treating the arrangements as precautionary.

Following the Executive Board's discussion on Honduras, Mr. David Lipton, First Deputy Managing Director and Acting Chair, made the following statement: "The Honduran authorities are implementing their Fund-supported economic program with strong commitment, amid improved terms of trade and strong remittance inflows.

"For 2015, the authorities have strengthened fiscal and monetary targets, taking advantage of the more favorable external environment to reduce the deficit of the central government and state electricity company (ENEE) at a faster pace than originally envisaged. This will add to the credibility of fiscal adjustment and enhance confidence. The authorities also plan to continue changing the composition of public expenditure to create room for higher and better-targeted social spending to support the reduction of the high levels of poverty.

"The tightening of monetary targets is important to strengthen international reserve buffers and help keep monetary policy focused on controlling inflation and protecting the external position. Plans to strengthen the central bank's governance and independence will enhance its capacity to maintain stable monetary and financial conditions.

"To bolster public finances and support long-run economic growth, the authorities should press ahead with reforms in the electricity sector. In particular, the authorities' plan to bring forward measures to reduce the deficit of ENEE is required to further lower the burden on the central government finances and increase efficiency. These measures should be accompanied by full implementation of the reforms envisaged in the 2014 electricity sector law, including the implementation of plans to reduce distribution losses in the sector.

"Finally, Honduras would benefit from protecting the hard won gains envisaged under the program by establishing a fully functional medium-term fiscal framework, which would institutionalize fiscal policy discipline. In addition, the provisions under the recently adopted social protection framework law should be implemented gradually to ensure consistency with the program's objectives and with long-term fiscal sustainability."

ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS

Pillar 1: Strengthening Institutional Arrangements to Support Fiscal Sustainability

Prior Action 1: The Government, through SEFIN, has: (a) approved and published on the Ministry's website a medium-term macroeconomic and fiscal framework that is consistent with the medium-term debt management strategy; and (b) submitted this framework to Congress.

Prior Action 3: The Government, through SEFIN, has: (a) approved and published on its website a medium-term public debt policy that establishes public debt ceiling recommended targets for state-owned enterprises, and borrowing guidelines for local governments; and (b) approved and published a calendar for debt issuance for 2015 and 2016.

Prior Action 4: The Government, through SEFIN, has: (a) created a budgeting module in the Integrated Financial Management System (SIAFI-GES) that specifies budget ceilings consistent with the medium-term macroeconomic and fiscal framework; and (b) submitted to Congress for approval the 2016 Budget Bill of Law that specifies processes for registering public trust funds in the budget (*Fideicomisos*).

1. **Measures aimed at improving the fiscal sustainability of the country are expected to have a neutral direct effect on poverty and inequality reduction.** However, to the extent that they reduce economic volatility, improve the quality of public spending, and protect the fiscal space necessary to preserve public spending targeted to help the most vulnerable segments of the population, these measures are important for long-term and sustainable poverty reduction. The measures undertaken under prior actions 1, 3 and 4 in the operation will improve the transparency, quality and enforcement of public sector budgets and financial management, with the expected result of slowing debt accumulation while increasing trust in public institutions.

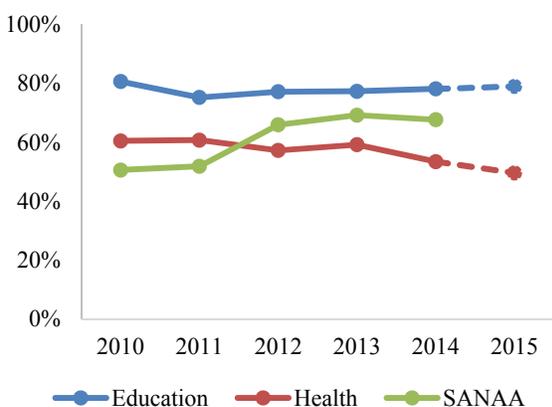
2. **Fiscal instability in Honduras is related to weak budgetary controls that cause spending to exceed projections, limiting resources available for public investment or countercyclical fiscal policies.** In recent years, annual budgetary ceilings have been routinely modified by Congress, superseding the original ceilings set by the Ministry of Finance. Due to an absence of ex-ante controls on budgetary commitments, new expenditure items have been introduced in the budget without a formal review process or evaluation. In this context, the establishment of a system to effectively control budget expenditures through the Integrated Financial Management System (SIAFI-GES) will contribute to greater efficiency of public spending.

3. **Given the country's fiscal constraints and the already high levels of spending on social sectors as a proportion of GDP, a focus on improving the efficiency of institutions is needed to expand opportunities.** In the education sector, for example, a projected 79 percent of spending in 2015 was on wages, leaving little room for investment, expansion of coverage, or improvements in quality even as the country has a shortage of approximately 1,000 schools (Figure 5). Similarly, SANAA – the water and sanitation public utility – spent two-thirds of its budget on wages, while about half of public spending on health was allocated to wages. One important step being undertaken across the public sector, and supported by the FY14 operation as well as the proposed operation for next year, is an evaluation of public sector employment, including institutional functional reviews across a majority of public institutions meant to curb the growth of the public sector wage bill. As noted in the Poverty and Social Impact Analysis for the 2014 DPC operation, only 3 percent of public sector workers are in the bottom 40 percent,

hence if the functional reviews were to lead to labor force reductions in some public agencies, the direct impact on poverty is expected to be small. As noted in that document, “In the medium-term... these reforms may lead to productivity increases as resources are reallocated to more efficient activities... and importantly, the creation of fiscal space made possible by this reform 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.”

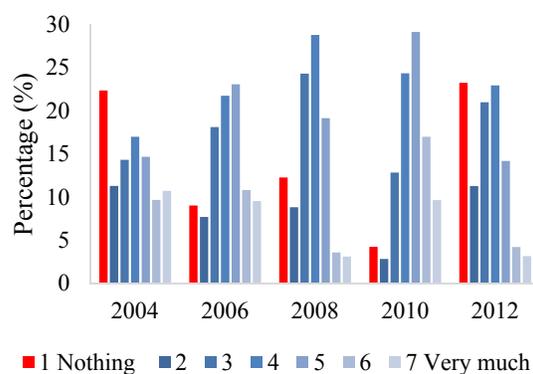
4. **Strong public sector financial management will not only contribute to fiscal sustainability but may also lead to increases in citizen trust in public institutions and the Government.** In the past eight years, levels of trust in national and local public institutions have worsened. In 2004, only a third of Hondurans reported having confidence in their national Government (Figure 6). By 2012, this already low number had fallen to 21 percent. Similarly, about one in five respondents in both years reported having absolutely no confidence in the Government. Increasing transparency and addressing inefficiencies in how public funds are allocated through these reforms can begin to rebuild public trust.

Figure 5. Salaries as a share of budgets by sector, 2010-2015



Source: Honduras SCD (2015)

Figure 6. Lack of trust in government is high in Honduras



Source: Latin American Public Opinion Project (LAPOP) “To what extent do you have confidence in the national government?”

Prior Action 2: The Government has approved and published an energy tariff structure that reduces the electricity subsidy for residential consumers.

5. **The reforms of ENEE, the public energy company, supported by this operation will contribute to improved fiscal sustainability by reducing the company’s losses through increased revenue but could potentially have negative effects on poverty in the short-term.** In 2013, residential customers consumed 40.7 percent of the electricity sold, but only paid for 31.3 percent of electricity sales, reflecting below-cost electricity subsidies and poor cost recovery mechanisms that hinder ENEE’s financial sustainability. Recent changes in residential subsidies will increase costs for some consumers. The households most likely to be adversely affected are those living in or near poverty with access to metered electricity and who consume more than 75 kWh per month; these will see electricity costs increase by 36 percent for the first 100 kWh per month and by 18 percent for the next 200 kWh (Table A1). For a household consuming 100 kWh

per month, this translates into an increase of almost 78 Lempiras per month in their electricity bill, the equivalent of 0.6 percent of the average monthly income of households with access to electricity.

Table A1. Electricity subsidies, December 2014

kWh per month	Tariff (Lempiras)			Subsidy	
	Jan-2009	Dec-2014	Change	Jan-2009	Dec-2014
0-100	1.4037	2.1835	36%	55%	30%
101-300	2.4955	3.057	18%	20%	2%
301-500	3.1193	3.1193	0%	0%	0%
501 and over	3.4313	3.4313	0%	-10%	-10%

Source: La Gaceta, Honduras.

6. **The changes in the subsidies make the system more progressive, but increases in tariffs will be felt most acutely by smaller consumers who will see relatively larger increases.** While data limitations mean that a relationship between electricity usage and income in Honduras cannot be established, it is reasonable to assume that smaller homes with fewer appliances have lower demand for electricity and that these are home to lower income families. The design of electricity subsidies in Honduras mitigates the potential for poverty impacts through two channels. First, households using less than 75 kWh/month, likely to be among the poorest, will continue to receive direct subsidies from the authorities, thus offsetting the increase in electricity tariffs. Second, though lowered, subsidies will remain in place and are now more progressive: for the first 100 kWh/month, consumers will receive a subsidy of 30 percent, and for usage of 100-300 kWh/month, consumers will be subsidized by 2 percent; subsidies for consumers of up to 100 kWh per month increased from more than three times those for consumers with up to 300 kWh per month to fifteen times higher. This represents improved targeting of public spending. Expansion of the country's CCT program and Platform *Vida Mejor* (Prior action 5) can further offset this change as they are expected to lead to increased household income or access to services for some households living in extreme poverty.

7. **The country's relatively low electrification rate further decreases the impact of the reduction of tariffs on poverty.** Despite the high public costs of ENEE, access to electricity is low among those living in poverty and extreme poverty. The bottom 40 percent of the population, all of whom live in extreme poverty, have low levels of electricity access: only 66 percent of the first income quintile, the poorest 20 percent of the population, and 81 percent of the second quintile (Figure 8). Coverage varies geographically - only 75 percent of rural households have electricity overall, while rates are exceptionally low in the east and the southwest, including parts of the Dry Corridor (Figure 7). ENEE reports that 23 municipalities remain without access to electricity (out of 298), and that an additional 24 municipalities have coverage rates of less than 50 percent.¹⁸ These are areas of the country that concentrate extreme poverty.

¹⁸ Empresa Nacional de Energía Eléctrica (ENEE), 2014. *Cobertura del Servicio de Energía Eléctrica en Honduras, 2014*.

Figure 7. Electricity Coverage by Location

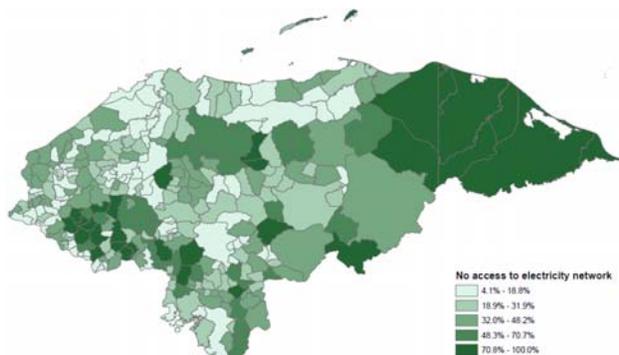
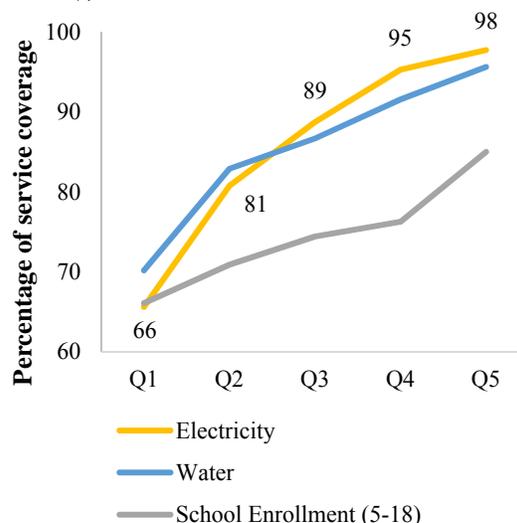


Figure 8. Service Coverage by Income Quintile (percent), 2013



Source: World Bank estimates based on preliminary 2013 census tabulations from Honduran authorities; SEDLAC (World Bank and CEDLAS).

8. **While low access rates among the rural population mitigate the extent to which the tariff increase directly affects the poorest Hondurans, it also underscores the importance of improving the fiscal situation of ENEE so as to create fiscal space to expand electricity coverage.** While electricity costs will increase for residential consumers, this will improve the sustainability of the energy sector while increasing incentives for efficient usage as tariffs will more accurately reflect costs. Beyond the need to continue expanding coverage, ENEE also needs to improve quality of coverage. For example, nearly 265,000 ENEE customers either do not have meters or do not have meters that are verified to be working properly and, as a result, are charged based on estimated usage rather than actual usage. Finally, the ongoing restructuring of the ENEE, in part supported by the second operation of this DPF, is expected to lead to increases in the company’s technical and managerial capacity. This is an important step in addressing the high public costs associated with this sector and reducing the company’s losses. 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.

Prior Action 5: The Government, through SEDIS has (a) expanded the coverage of the *Bono Vida Mejor* conditional cash transfer program to children attending 7th to 9th grade of lower secondary education; and (b) approved a methodology to prioritize the coverage of the Platform *Vida Mejor* in 141 municipalities most affected by poverty, vulnerability, violence and migration.

Prior Action 6: INE has: (a) published the full documentation and metadata of the 2013 Population Census through Redatam; and (b) published the tabulations of the EPHPM and the 2013 Population Census on its website.

9. **The expansion of coverage of the *Bono Vida Mejor* is expected to reduce extreme poverty and increase enrolment in lower secondary school, and the prioritization of the**

Platform *Vida Mejor* is expected to reduce extreme poverty in the 141 target municipalities. While the publication of socioeconomic data is expected to have neutral direct effects on poverty and equity, increased access to this information may lead to improved targeting of social spending.

10. **In 2013 65 percent of Honduran households lived in poverty and 43 percent in extreme poverty.** The bottom 40 percent has income levels of under US\$2 per day per person, household heads with less than four years of schooling and are primarily rural and relying on self-employment and the primary sector for income (Table A2). These households also have more children relative to adults in the household: a third of the population in the bottom 20 percent were children 12 years of age and younger. The combination of more dependents and more volatile income sources suggest that the poor are also less resilient to shocks and less able to adjust their labor force and consumption patterns. Even so, around a third of the poorest 40 percent of the population was not covered by any social program in 2013.

Table A2. Demographic and Economic Profile, by income quintile (2013)

	Q1	Q2	Q3	Q4	Q5
Daily income pc (2005 US\$)	0.81	1.92	3.24	5.33	16.56
Education of head (years)	3.25	3.66	4.31	5.69	8.87
Household size	5.14	4.93	4.61	4.14	3.48
Live in urban area (%)	23.14	33.98	44.08	60.29	70.98
Proportion age 0-12 (%)	33.1	29.8	26.5	21.2	13.3
Proportion age 13-18 (%)	14.7	15.4	15.2	14.5	9.42
Primary sector (%)	73.3	52.4	35	20.3	12.3
Self-employed (%)	42.5	38.8	32.9	27.6	21.7

Source: SEDLAC (CEDLAS and the World Bank)

11. **The past 15 years has seen the rise of crime and migration as self-reinforcing cycles that limit growth and opportunities in Honduras.** As noted in the SCD, breaking these cycles requires a “big push”, including social assistance for the most vulnerable and improved educational outcomes. Through prior action 5, the Government aims to address these cycles head on by using crime and migration as part of its prioritization strategy, while also encouraging increased education by including secondary school children in the *Bono*.

12. **Given the limited fiscal space for public spending - public transfers only represented 1.6 percent of GDP in 2012 - and the country’s high poverty rates, effective targeting and prioritization of spending is crucial.** In earlier reforms that were part of the 2014 Fiscal Sustainability and Enhanced Social Protection DPC, targeting of the *Bono Vida Mejor* was altered from households living in poverty to those living in extreme poverty. Prior action 5b introduces the prioritization of 141 municipalities identified as particularly vulnerable due to high poverty, high crime and high outmigration rates. Specifically, the Government aims to provide coverage under the Platform *Vida Mejor* for all households living in extreme poverty in these communities in an effort to break these self-reinforcing cycles.

13. **Honduras faces significant challenges in coverage, equity and quality of education.** Even though primary education (grades 1 through 6) is nearly universal, access at all other levels

of education continues to be strikingly low. Honduras has the highest dropout rate in secondary school in Central America, with Costa Rica and Panama observing the highest enrollment rates in secondary schooling (75 percent) and Honduras the lowest (46 percent). Dropout rates in lower secondary schooling are higher for boys (19 percent) than for girls (14 percent). Moreover, Honduras is the only country in Central America where the majority of students cite economic constraints as their main reason for dropping out. In 2013, 53 percent reported economic constraints as the main factor, while only 29 and 14 percent cited a lack of interest in studying or access to schooling, respectively.¹⁹ These high dropout rates have important consequences for economic productivity, growth inclusiveness and risks for the youth. In addition to low access, quality is fairly low in Honduras, with only one third of the students who finish secondary education able to achieve satisfactory scores in tests to enter higher education.

14. Improved access to the country’s socioeconomic data, particularly the release of the 2013 census tabulations, is expected to improve public policy design while also increasing the transparency of public spending. Good quality data is not just crucial for the design of public policies but also for the development of new analysis and research that could further policy design. Among the actions being undertaken in this direction is the creation of a Technical Committee tasked with developing a multidimensional poverty index. This Committee 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 in Honduras. As public trust in the public sector is low in Honduras by international standards, this open process may be a significant step forward in increasing public trust in institutions. Positive impacts on policy design for effective poverty reduction and shared prosperity are expected through improved identification and differentiation of monetary and non-monetary deprivations and improved spatial information on poverty through the release of census data and an updated poverty map. Similarly, greater accessibility and documentation of statistical information will contribute to stronger policy design and facilitate important policy evaluations.

Pillar 2: Enhancing the Regulatory Framework to Promote Competitiveness

Prior Action 7: The Government has: (a) adopted the amended Competition Law which creates a Leniency Program that provides incentives for corporations and individuals that report and cooperate in the investigation of cartel practices; and (b) issued regulations that detail the procedures for the Competition Authority to implement the Leniency Program.

Prior Action 8: The Government has submitted to Congress for approval a Trade Facilitation Agreement with the World Trade Organization.

15. Reforms related to increasing competitiveness are not expected to have direct impacts on poverty, but have the potential to have positive distributional impacts. In the medium- to long-term, these may be pro-poor to the extent that they foster sustainable job growth and reduce costs of goods and services. As shown in the SCD, the Honduran labor market suffers from low labor force participation (particularly among women and youth), high urban unemployment for some groups, and a high concentration of workers in low-productivity informal employment. A full 80 percent of jobs are in the informal sector and a majority of the

¹⁹ Adelman and Szekely (forthcoming) *School dropout: unresolved issues and new challenges for education progress in Central America*. Washington, DC. World Bank.

recovery in jobs seen since the 2009 crisis has been the result of increased self-employment, not job creation by firms. As of 2013, Honduras had the highest self-employment rate in Central America, with self-employment accounting for more than four out of ten jobs. Honduras has a shortage of jobs.

16. **Firms tend to be less productive and less competitive abroad when they face weak competition pressures in domestic markets, with the result that consumers are left with higher prices and lower quality products domestically.** Prior action 7 supports the adoption and implementation of a Leniency Program, which undermines incentives for collusion and other anti-competitive practices in the market. This type of behavior tends to favor incumbent firms and hurt the prospects of new firms. Prior action 8 is expected to reduce costs associated with importing and exporting, potentially increasing access to international markets for smaller firms. As small and young firms generate a disproportionate share of job creation, both actions may lead to increased labor demand.