

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**HONDURAS**

**FISCAL CONSOLIDATION SUPPORT PROGRAM**

**(HO-L1103)**

**LOAN PROPOSAL**

This document was prepared by the project team consisting of: This document was prepared by the project team consisting of Edna Armendáriz (IFD/FMM), Project Team Leader; Belinda Pérez Rincón (FMM/CDR); Gerardo Reyes-Tagle (IFD/FMM); Alberto Barreix (IFD/FMM); Mariano Lafuente (IFD/ICS); María José Jarquín (IFD/ICS); Waldo Andrés Tapia (LMK/CPR); Pilar Jiménez de Arechaga (LEG/SGO); Alejandro Quijada (CID/CHO); Nalda Morales (FMP/CHO); María Cecilia del Puerto Correa (FMP/CHO); Marcio Cracel y Ana Calvo (consultants); and Lorena Kevish (IFD/FMM).

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## ABBREVIATIONS

CNBS	Comisión Nacional de Bancos y Seguros [National Banking and Insurance Commission]
DEI	Dirección Ejecutiva de Ingresos [Executive Revenue Directorate]
ENEE	Empresa Nacional de Energía Eléctrica [National Electricity Company]
FAD	Fiscal Affairs Department
IFD/FMM	Fiscal and Municipal Management Division
IHSS	Instituto Hondureño de Seguridad Social [Honduran Social Security Institute]
IMF	International Monetary Fund
INJUPEMP	Instituto Nacional de Jubilaciones y Pensiones de los Empleados y Funcionarios del Poder Ejecutivo [National Retirement and Pensions Institute for Executive Branch Employees]
INPREMA	Instituto Nacional de Previsión del Magisterio [National Teacher's Pension Fund]
IPM	Instituto de Previsión Militar [Military Pension Institute]
ISV	Impuesto Sobre las Ventas (sales tax)
LIBOR	London Interbank Offered Rate
MTEF	Medium-term Expenditure Framework
MTMF	Medium-term Macro-fiscal Framework
PPP	Public-private partnership
SAR	Servicio de Administración de Rentas [Revenue Administration Service]
SCF	Single Currency Facility
SEFIN	Ministry of Finance
SIREP	Sistema de Registro y Control de Empleados Públicos [System for the Registration and Supervision of Public Employees]
SMEs	Small and medium-sized enterprises
SNIP	Sistema Nacional de Inversión Pública [National Public Investment System]
UCF	Unidad de Contingencias Fiscales [Fiscal Contingencies Unit]

**PROJECT SUMMARY**  
**HONDURAS**  
**FISCAL CONSOLIDATION SUPPORT PROGRAM**  
**(HO-L1103)**

Financial Terms and Conditions					
<b>Borrower:</b> Republic of Honduras <b>Executing agency:</b> Ministry of Finance (SEFIN)				<b>Ordinary Capital</b>	<b>Fund for Special Operations</b>
Source	Amount (US\$ million)	%	Amortization period:	30 years	40 years
IDB Ordinary Capital:	36	60	<b>Disbursement period:</b>	1 year	1 year
			<b>Grace period:</b>	6 years	40 years
IDB Fund for Special Operations:	24	40	<b>Inspection and supervision fee:</b>	(a)	N/A
			<b>Interest rate:</b>	SCF Fixed <sup>(b)</sup>	0.25%
			<b>Credit fee:</b>	(a)	N/A
<b>Total:</b>	60	100	<b>Currency of approval:</b>	United States dollars	
Project at a Glance					
<b>Project objective/description:</b> The main objective of the program is to support fiscal consolidation in Honduras through policy measures to strengthen macro-fiscal management, increase tax revenue collection, enhance public expenditure management, and improve the management of fiscal risks associated with contingent liabilities.					
This operation is the first of two in a programmatic series of policy-based loans.					
<b>Special contractual conditions:</b> The sole disbursement is contingent upon compliance with the policy reform conditions laid out in the policy matrix (Annex II) and policy letter, and with the conditions established in the loan contract (paragraph 3.3).					
<b>Exceptions to Bank policy:</b> None.					
<b>Project qualifies as:</b> <sup>(c)</sup> SV <input checked="" type="checkbox"/> PE <input type="checkbox"/> CC <input type="checkbox"/> CI <input type="checkbox"/>					

(a) The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans.

(b) The borrower will pay interest on the outstanding balances of the Ordinary Capital portion of the loan at a LIBOR-based rate. Once the outstanding balance reaches 25% of the net amount approved or US\$3 million, whichever is greater, the base rate will be set for this balance.

(c) SV (Small and Vulnerable Countries), PE (Poverty Reduction and Equity Enhancement), CC (Climate Change, Sustainable Energy, and Environmental Sustainability), CI (Regional Cooperation and Integration).

## I. DESCRIPTION AND RESULTS MONITORING

### A. Background, problem addressed, and rationale

- 1.1 **Macroeconomic context.**<sup>1</sup> Honduras saw real GDP growth of 3.1% in 2014, compared to 2.8% in 2013. Private gross investment and private consumption were the main drivers of economic activity, growing by 2.7% and 2.9%, respectively. Real GDP growth of 3.0% to 3.5% is expected in the short and medium term, due to a more favorable external environment associated with economic recovery in the United States<sup>2</sup> and improved terms of trade (i.e. lower oil prices and higher coffee prices). In the first half of 2015, the Honduran economy grew by 3.6% year-on-year—above the 2.7% recorded in the same period of 2014.
- 1.2 External sector trends have been favorable. The current account deficit fell from 9.5% of GDP in 2013 to 7.4% in 2014. This deficit is mainly the result of the trade imbalance, which is offset by substantial flows of remittances that create a surplus on the transfers account. At the same time, the surplus on the capital and financial account has been maintained, reaching 9% of GDP in 2014, mainly as a result of foreign direct investment (5.9% of GDP).
- 1.3 As of June 2015, net international reserves stood at US\$3.873 billion, equivalent to 4.1 months of imports. In terms of the exchange rate, there was a depreciation of 4.8% year-on-year over the same period—higher than the 2.7% recorded in June 2014.<sup>3</sup> Inflation was 5.8% in 2014, which was within the band of 5.5% to 7.5% established by the Central Bank of Honduras; in 2015, it is expected to decelerate to a range of 3.75% to 5.75%. Inflation of around 4% to 5% per year is expected in the short and medium term.
- 1.4 **Fiscal context.** Fiscal performance has improved subsequent to the deterioration in public finances from 2007 to 2013. The central government fiscal deficit fell from 7.9% of GDP in 2013 to 4.4% in 2014. Over the same period, central government debt rose from 42.6% of GDP to 45.7%.<sup>4</sup> The upward trend in public expenditure was reversed, falling from 24.9% of GDP in 2013 to 23.2% in 2014, particularly as a result of a reduction in current spending. Tax pressure rose from 15.3% of GDP in 2013 to 16.3%<sup>5</sup> in 2014, mainly owing to an increase in the general sales tax (ISV) rate. The net financing requirement is expected to reach 2.4% of GDP in 2015. The government expects to tap external sources of financing for US\$260 million and domestic ones for US\$320 million. The present operation represents 12.5% of net financing needs and 23.1% of the total from external sources.

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<sup>1</sup> Source: Ministry of Finance (SEFIN), Central Bank of Honduras, and International Monetary Fund.

<sup>2</sup> The United States is Honduras' main trading partner and the source of a large part of its remittance flows.

<sup>3</sup> The exchange rate regime consists of a system of bands, with foreign exchange allocated through daily auctions. The Central Bank auctions foreign exchange within a +/- 7.0% band around the base rate; the band is modified after each five auctions in accordance with certain criteria.

<sup>4</sup> General government debt rose from 45.3% of GDP in 2013 to 46.1% in 2014.

<sup>5</sup> This excludes the "security tax", which is a special contribution administered by the Fondo de Protección y Seguridad [Protection and Security Fund] and used for the security of the population. The following items are subject to the tax: (i) financial transactions (88%); (ii) environmental protection (6%); (iii) fast food (4%); and (iv) mobile telephony, the cooperative sector, and casinos and slot machines (2%).

- 1.5 The balance for nonfinancial public enterprises is mainly determined by the deficit of the Empresa Nacional de Energía Eléctrica [National Electricity Company] (ENEE) (1.8% of GDP in 2013), which has affected the overall public sector deficit (7.2% of GDP in 2013).<sup>6</sup> The ENEE's deficit was reduced to 1.3% of GDP in 2014 as a result of a series of Bank-supported measures to improve the company's financial situation in late 2014,<sup>7</sup> including a reduction in energy losses, administrative restructuring, a rate adjustment, and a new legal and regulatory framework for the sector. Electricity sector reforms and improved financial and operational management of the ENEE made it possible to reach the targets set in the program with the International Monetary Fund (IMF) in mid-2015.<sup>8</sup> Those efforts have helped to reduce the overall public sector deficit (4% of GDP in 2014) and contributed to gains in strengthening public finances.
- 1.6 **Fiscal consolidation strategy.** The Government of Honduras's economic and social development policies seek to restore macroeconomic stability and consolidate the public finances. These measures aim to reduce the public sector fiscal deficit and contain growth in the public debt. Reforms approved in 2013 to reduce public spending and increase revenue were implemented in 2014,<sup>9</sup> including an increase in the general ISV rate from 12% to 15%, a 25% increase in the gasoline and diesel tax, the introduction of a 1.5% payment on individual and corporate gross incomes of 10 million lempiras or more,<sup>10</sup> a reduction in the electricity subsidy, and a reduction in transfers to decentralized entities (municipios and public universities).
- 1.7 This program supports actions by the Government of Honduras to reduce payroll spending<sup>11</sup> and improve efficiency in the procurement of goods and services. It also supports modernizing tax administration, improving the institutional framework for public-private partnerships (PPPs) to reduce fiscal risks that have arisen in the past,<sup>12</sup> and optimizing human resource management and

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<sup>6</sup> The overall public sector deficit includes the nonfinancial public sector and Central Bank of Honduras quasi-fiscal losses. The social security agencies generate a positive balance overall, offsetting the ENEE deficit.

<sup>7</sup> Programmatic Support for Structural Reforms in the Electricity Sector (loan 3386/BL-HO).

<sup>8</sup> The targets include a reduction in the company's overall net deficit, an increase in the ratio of operating revenues to current expenditure, nonaccumulation of new payment delays with respect to energy suppliers, and stabilization of the floating debt.

<sup>9</sup> Ley de Ordenamiento de las Finanzas Públicas, Control de Exoneraciones y Medidas Anti-evasión [Law for the Structuring of Public Finances, Control of Exemptions, and Anti-Evasion Measures] (278-2013, 21 December 2013).

<sup>10</sup> Approximately US\$454,000 at the end-July 2015 exchange rate.

<sup>11</sup> Since 2010, the Government of Honduras has made significant efforts to contain growth in the wage bill through measures to strengthen controls in the education sector. By 2014, these measures had led to a reduction of 1.8 percentage points in the wage bill.

<sup>12</sup> The limit on the use of PPPs (the cumulative net present value of all approved projects) according to the 2010 law is already estimated to have exceeded the maximum of 5% of GDP (see [The Fiscal Implications of Public-Private Partnerships in Honduras: Current Developments and the Road Ahead](#)).

institutional strengthening to improve the financial situation and management of public pension funds.<sup>13</sup>

- 1.8 These reforms facilitated the adoption of a Stand-By Arrangement with the IMF in December 2014, with fiscal targets through 2017. That arrangement supports the government's economic program for restoring fiscal discipline. The target is for an increase in tax revenue to 17.5% of GDP, as well as a gradual reduction in current spending to 22.7% of GDP by the end of 2017. The measures are expected to allow a reduction in the consolidated public sector deficit to 1.8% of GDP. Consolidation of the fiscal accounts will create the conditions for greater and improved investment in social areas that benefit the poorest sectors in the country.<sup>14</sup>
- 1.9 **Problems and their causes.** To meet these targets, efforts need to be intensified to ensure stability in the public finances through measures to strengthen macro-fiscal management, modernize tax administration, and improve efficiency and transparency in public spending, and to mitigate risks associated with contingent liabilities. The main problems are focused in the following areas.

### 1. Macro-fiscal management

- 1.10 There are weaknesses in the institutional framework and in the macro-fiscal management instruments for consolidating the fiscal measures in the medium term. The main causes of this problem are as follows:
- a. The absence of regulations with clear rules and sanctions to ensure the credibility, predictability, and transparency of fiscal policy, and, accordingly, the maintenance of fiscal discipline by the government (IMF Fiscal Affairs Department [FAD], p. 44).<sup>15,16</sup> As a result, Honduras's public finances have been affected by ongoing fiscal instability, and efforts to improve macro-fiscal management have been transitory. Such legislation would help to anchor recent efforts to strengthen fiscal policy in a sustainable manner.
  - b. Low institutional capacity in the Ministry of Finance (SEFIN), and inadequate instruments for macroeconomic and fiscal analysis and for establishing medium-term targets consistent with economic stability. There are also inconsistencies between SEFIN and the Central Bank of Honduras in terms of the data that is included below the line (FAD, p.42). In addition, SEFIN lacks a unit with suitable procedures for performing macro-fiscal analysis functions (FAD, p. 37).

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<sup>13</sup> The public pension system comprises five funds that use a pay-as-you-go system: Instituto Hondureño de Seguridad Social [Honduran Social Security Institute] (IHSS); Instituto Nacional de Previsión del Magisterio [National Teacher's Pension Fund] (INPREMA); Instituto Nacional de Jubilaciones y Pensiones de los Empleados y Funcionarios del Poder Ejecutivo [National Retirement and Pensions Institute for Executive Branch Employees] (INJUPEMP); Instituto de la Universidad Nacional Autónoma de Honduras [Institute of the National Autonomous University of Honduras] (INPREUNAH); and Instituto de Previsión Militar [Military Pension Institute] (IPM).

<sup>14</sup> Honduras's poverty rate reached 64.5% in 2013, and a high level of income inequality persists (Gini coefficient of 0.57). World Development Indicators.

<sup>15</sup> Review of the Medium-term Fiscal Framework and Debt Policy Document (FAD, 2015).

<sup>16</sup> There is evidence of the effectiveness of public expenditure rules, which promote greater control in expenditure and improve fiscal discipline (Cordes et al., 2015).



## **2. Tax and customs revenue management**

- 1.11 Despite recent improvements, tax collection is still insufficient to finance public spending on priority areas in a sustainable manner. The tax burden reached 16.3% of GDP in 2014, which was similar to both the 2007 level (despite an ISV rate that was three percentage points lower) and the average for Latin America. The main causes of this problem are as follows:
- a. The Executive Revenue Directorate (DEI), which is responsible for tax and customs administration, suffers from deficient tax processes that hinder its ability to enforce the legal framework in Honduras. It also has weaknesses in terms of generating reliable, timely data for effectively scrutinizing and billing taxpayers. The agency's human talent also lacks the qualifications necessary to carry out its institutional mandate.<sup>17</sup>
  - b. ISV enforcement is weak owing to a lack of adequate tools for the monitoring and audit of taxpayers—for example, electronic invoices. In 2013, 893,904 taxpayers were listed in the National Tax Registry (RTN), yet only 16,831 invoices were issued in the eTAX system—1.9% of the total. The procedure for reviewing ISV invoices is largely a formality and the supporting documentation is not reviewed (FAD, p. 19).<sup>18</sup>
  - c. Certain sectors of the economy enjoy excessive tax concessions (e.g. the maquila sector, tourism); there are not proper controls over this process, nor any quantification of the costs. Tax expenditures are not subject to any transparency-related controls (there are no records of the beneficiaries of the tax breaks), nor are there formal procedures for estimating and evaluating tax expenditures, which stand at around 7% of GDP (Gómez et al., 2012).
- 1.12 The government has decided to implement structural reforms in relation to customs and tax administration, including the creation of a Revenue Administration Service (SAR) to replace the DEI. It has requested Bank support under recently approved investment loan 3541/BL-HO for the investments required to implement these reforms. The main arguments for the reform are (i) the need to implement a new human resources policy and restore the corporate image of the tax administration (disassociating it from the DEI), which prompted the creation of the SAR; (ii) the confirmed need to replace a large part of the tax administration's technical staff (paragraph 1.11a); and (iii) significant evidence of a lack of transparency and integrity in key areas of the tax administration (paragraph 1.11a). The decision to totally replace the staff complement was driven by the prime risk that newly recruited staff would be contaminated.

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<sup>17</sup> The majority of DEI administrative and technical staff lack the basic qualifications and levels of education required to effectively perform the tax administration function. Only 34% of employees have a university degree. Failings in the professional ethics of staff have also been documented. Of a sample of 851 individuals that were subjected to a lie detector test (polygraph), 30% failed.

<sup>18</sup> Structural Issues for Strengthening the DEI (FAD, 2014).

### 3. Public expenditure management

- 1.13 Low institutional capacity for administering and controlling public funds affects the quality of expenditure in terms of its efficiency and transparency. The main causes of this problem are as follows:
- a. The budget is prepared based on a short-term vision (of just one year). Formally, program-based budgeting is the technique used, but in practice the budget is incremental in nature, based on the amounts allocated in past years; medium-term sector strategies are not taken into account (IFD/FMM, 2014). Similarly, there are no instruments to encourage the different institutions responsible for expenditure to identify and eliminate nonpriority spending. The budget is not used as budgetary restriction instrument consistent with medium-term fiscal sustainability. The approved budget is also subjected to substantial modifications that are reflected in a budget gap<sup>19</sup> of as much as 23% (SEFIN, 2012).
  - b. Public wage spending is high,<sup>20</sup> stemming from growth in the payroll<sup>21</sup> and the absence of reliable, organized, and relevant data in various sectors of the centralized and decentralized public administration. This makes it difficult to confirm the accuracy of wage spending data (particularly health and public works). At the same time, inadequate controls in the decentralized public sector have led to a high level of employment in key public enterprises such as the ENEE, the national telecommunications company (HONDUTEL), and the National Autonomous Water and Sewerage Service (SANAA), and this has had a major impact on the consolidated public sector fiscal deficit (paragraph 1.5). Although decree PCM-028-2014 created the Commission to Reform the Central Government and Decentralized Institutions, concrete measures need to be implemented to achieve a more transparent and efficient wage bill.
  - c. There is a low level of transparency in the execution of nonbudgetary funds managed by trusts. There are no explicit procedures for budget execution and record-keeping by the trusts.<sup>22</sup> The growing trend towards creating trusts for public sector activities reduces transparency in the execution of spending, distorts execution data,<sup>23</sup> hinders timely understanding of the fiscal situation (SEFIN only receives monthly information regarding trust balances); and imposes additional costs on the government in the form of fees, as well as

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<sup>19</sup> The divergence between the originally approved budget and the budget as ultimately executed (Makon, M., 2013).

<sup>20</sup> As a proportion of GDP and the budget, the central administration in Honduras has one of the highest levels of spending on public employees in Latin America (9.1% and almost 40%, respectively, in 2014) (Dumas et al., 2014).

<sup>21</sup> Central government wage spending rose by almost two percentage points of GDP between 2007 and 2011.

<sup>22</sup> There are approximately 90 trusts. According to a December 2014 report, three of these account for 7.5% of the budget (source: SEFIN). They are: (i) the security tax, or Protection and Security Fund; (ii) the Solidarity and Social Protection Fund for the Reduction of Extreme Poverty; and (iii) the Fund for the Reactivation of the Agricultural Sector (FIRSA).

<sup>23</sup> Expenditure is considered to have been executed when the resources are transferred to the trust, and not when the trust pays for a good or service.

opportunity costs in the case of resources that some trusts do not manage to execute (FADa, p.41).

- d. The efficiency and transparency of public procurement processes is low. Based on an analysis of projected costs and savings, this is partly due to poor prevailing practices, which are repeated across all state institutions and have a disproportionate effect on public spending. These include (i) a failure to exploit potential economies of scale through bulk purchases;<sup>24</sup> (ii) a lack of standardization and cataloging of goods and services; (iii) the difficulty of establishing comparable reference prices; and (iv) a lack of mechanisms to support transparency in processes and access to information.<sup>25</sup>

#### **4. Management of contingent liabilities**

- 1.14 The problem lies in a failure to identify, quantify, and mitigate fiscal risks associated with public-private partnerships (PPPs) and the pension system.
- 1.15 In the case of PPPs, the main causes of this problem are as follows:
  - a. Institutional weaknesses in SEFIN and the Commission to Promote Public-Private Partnerships (COALIANZA)<sup>26</sup> with respect to the management and development of PPPs; this is accentuated by the lack of an adequate legal framework and the absence of institutional arrangements between the two entities. Although the legal framework establishes that National Public Investment System (SNIP) procedures must be used in the case of PPPs, in practice these are not registered in the SNIP. This has created risks for fiscal sustainability in the medium term: the rate of growth in guaranteed minimum PPP revenues is expected to outpace that of GDP over the 2013-2019 period (Reyes-Tagle et al. 2015, p.12).
  - b. Weaknesses in the organizational structure and in the tools for identifying, mitigating, and monitoring risks resulting from contingent obligations. PPP rules and regulations do not include any analysis of fiscal risks, and no guidelines have so far been prepared (Reyes-Tagle et al., 2015, p. 24). Furthermore, there is still no adequate monitoring of PPP execution or compliance with contract terms (FAD, p. 38).
- 1.16 In the case of the pension system, the main causes include:<sup>27</sup>
  - a. An outdated regulatory framework for pension system investments. Current investment regulations applicable to pension institutions are out of date and lack some of the minimum features necessary for risk management in line with international best practices. The current regulations, issued by the National Banking and Insurance Commission (CNBS), allow investments in

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<sup>24</sup> Potential savings from mechanisms to consolidate purchases (e.g. product standards and specifications) are estimated at 5% to 25% of the total executed budget.

<sup>25</sup> [Honduras Public Expenditure and Financial Accountability \(PEFA\)](#) Follow-on, 2012.

<sup>26</sup> COALIANZA is responsible for managing projects and processes for the execution, development, and administration of public works and services with public-private participation.

<sup>27</sup> For greater detail regarding the state of the pension system, see the document “Diseño del Marco Regulatorio para las Inversiones de los Fondos Públicos por parte de los Institutos de Previsión de Honduras” [Design of the regulatory framework for the investment of public funds by pension funds in Honduras].

instruments without any minimal analysis of risk levels.<sup>28</sup> Investments, moreover, are highly concentrated in public sector instruments that are not redeemable on the secondary market or in the short term. This generates significant risks as a result of poor diversification and a failure to exploit liquidity premiums (pension funds have the ability to invest in longer-term instruments as they do not face short-term liquidity needs).<sup>29</sup> The lack of an appropriate regulatory framework has translated into inadequate decisions and significant asset losses that have intensified problems of financial sustainability and constitute a potential liability for the State.<sup>30</sup>

- b. The corporate governance rules applicable to these investments do not allow for adequate control of pension fund operations.<sup>31</sup> Most pension fund investments are made without reference to technical investment criteria, and they have been exposed to risks stemming from conflicts of interest, a lack of transparency, and management problems. This has led to both lower yields and an increase in risks associated with investment processes. Although the institutions have investment committees, these are token in nature and are not focused on managing investment risks. At the same time, the members of these committees lack the knowledge, experience, and technical skills needed to monitor and execute investment policies and strategies. The failure to modify corporate governance policies and standards, together with the committee members' lack of professional qualifications, has led to poor practices with resulting high administrative expenses and erroneous operational and financial decisions.

- 1.17 This operation envisions policy actions to mitigate all of the challenges presented in the diagnostic assessment of problems. These actions, in turn, will facilitate implementation of the Government of Honduras' economic and social development policies that aim to consolidate the public finances. Accordingly, the program's strategy is to attenuate the problems contributing to increases in the public sector fiscal deficit and growth in the public debt by means of actions to improve macro-fiscal management, boost tax revenue, make public spending more efficient, and strengthen the management of contingent liabilities. In this regard, the first operation strengthens the regulatory framework in key areas with a direct impact on the revenue and expenditure performance. The second

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<sup>28</sup> In 2014, 55% of revenues of the retirement and pension funds (INPREMA, INJUPEMP, and IPM) were generated by yields on their financial investments. As a result, the quality of the investment process affects the overall public sector balance.

<sup>29</sup> As of June 2015, 54% of financial investments were set to mature over the subsequent 12-month period, and 46% of investments were in public debt securities (Central Bank of Honduras, SEFIN, and Banco Hondureño para la Producción y la Vivienda–BANHPROVI).

<sup>30</sup> Fiscal risks associated with the pension system stem not only from poor investment policy, but also an inappropriate benefit structure. The Social Security Framework Law does not include parametric reforms that would allow for a better match between contributions and benefits. These changes will be included in a new IHSS law. In contrast, adjustment of the regulatory framework for investments is of importance given the statement in the Framework Law (Article 37) that the investment portfolio created using the reserves of the public pension funds must be invested in public securities or other investments mandated in law or in regulations issued by the CNBS, consistent with optimum criteria of security, liquidity, and profitability.

<sup>31</sup> Current corporate governance regulations were issued by the CNBS and are applicable to all financial system institutions. There are no regulations specifically applicable to public pension funds.

operation, consequently, consolidates this strengthening by implementing concrete actions to ensure the effectiveness of the respective policy actions.

- 1.18 **Bank strategy in the country and the sector.**<sup>32</sup> The Bank has provided assistance in the process of strengthening the public finances in Honduras, and this operation will provide added impetus to the ongoing support that has been provided to the country. In 2006, the Bank supported reforms to improve effectiveness and efficiency in the use of public funds (1748/SF-HO–Public Management Reform Program). The Bank has supported strengthening of the tax system—specifically, through a 2010 reform (Law 17-2010) to eliminate the ISV zero rate and expand the income tax base, among other things (2452/BL-HO–Fiscal Reform Support Program), and through technical assistance in 2013 for the design of a reform to increase the ISV rate by three percentage points (Law 278-2013). The Bank has also promoted modernization of national and municipal financial management systems with a view to improving expenditure controls and accountability (2032/BL-HO–Fiscal and Municipal Management Consolidation Program). Support has been provided for new processes and improvements to operational infrastructure in the customs administration, so as to raise service quality and strengthen security and control (2467/BL-HO–Puerto Cortés Customs Modernization Program; 2470/BL-HO–Puerto Cortés Expansion and Modernization Program). The Bank has provided assistance with respect to the strengthening of macro-fiscal management to build institutional capacities to analyze and evaluate fiscal policies (ATN/OC-14216-HO–Improvement of Fiscal Governance in Honduras).
- 1.19 In 2011, the Bank also supported reform of the pension institutions and the human resources management system (2627/BL-HO–Support Program for Reform of Pension Institutions and the Human Resources Management System; ATN/FI-12821-HO–Support to the Social Security and Civil Service Systems). Assistance has also been provided to analyze coverage of the social security system (ATN/OC-14047-HO–Options to Finance the Extension of Social Security Coverage) and improve human resources efficiency (ATN/FI-14338-RG–Improving the Efficiency of Public Sector Human Resources). As a result of Bank support, significant gains have been made in tax policy, customs control processes and systems, national and subnational financial management, and reforms of the INPREMA and INJUPEMP pension funds. With respect to the control and quality of public spending, there have been some improvements in personnel spending and in the procurement of goods and services, however the efforts still need to be institutionalized. Progress has been slower in macro-fiscal management and management of fiscal risks associated with contingent liabilities.
- 1.20 This program provides continuity to Bank support for the process of fiscal consolidation in Honduras, which began in 2014 with an electricity sector operation (3386/BL-HO–Programmatic Support for Structural Reforms in the Electricity Sector). Similarly, it supports policy reforms to modernize tax administration, thus complementing the recently approved investment loan to implement tax administration reform (3541/BL-HO).

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<sup>32</sup> See the [summary table of recent operations in the fiscal area in Honduras](#) described in this section.

- 1.21 **Lessons learned.** This operation builds on the lessons learned from past operations (2452/BL-HO, 2032/BL-HO, 1748/SF-HO, 2452/BL-HO, and 2627/BL-HO), including the importance of ensuring sustainability in fiscal efforts by deepening support for macro-fiscal management;<sup>33</sup> the complementarity of policy actions and investments to control public spending;<sup>34</sup> the need to provide high-level technical assistance during the preparation stage to ensure compliance with conditionalities; and the importance of SEFIN's central strategic leadership in coordinating stakeholders (for example, the DEI in the fiscal area and the CNBS in the pensions area).<sup>35</sup> Design of the operation incorporated the lessons for the fiscal area included in the [Country Program Evaluation: Honduras 2011-2014](#), such as (i) promoting policy measures aimed at strengthening institutional management capacity and governance, so as to ensure greater sustainability in reform processes; and (ii) continuing to coordinate with the IMF and the World Bank with the aim of ensuring a sustained process of fiscal consolidation.
- 1.22 This operation also takes into account the lessons learned from measures to contain wage spending in program 2627/BL-HO and in studies from Central America and the Dominican Republic (ATN/FI-14338-RG). Based on the aforementioned operations, the following conditionalities related to the control of wage spending have been included in the program: (i) strengthening controls over the creation of new positions and implementation of the System for the Registration and Supervision of Public Employees (SIREP); (ii) implementing payroll audits in key sectors to detect irregularities; and (iii) online publication of remuneration information through SIREP.
- 1.23 This operation has been coordinated with the IMF (monitoring of the Stand-by Arrangement with the Government of Honduras) and the World Bank (preparation of a budget support operation).<sup>36</sup> A few diagnostic assessments carried out by these institutions in the area of public finances have also been used.
- 1.24 **Strategic alignment.** The program is aligned with actions envisioned under the Plan of the Alliance for Prosperity in the Northern Triangle, in terms of its strategic line of action relating to strengthening institutions (specifically, actions to strengthen tax administration and improve the transparency and effectiveness of expenditure). The project is also aligned with the sector priorities laid out under the fiscal consolidation pillar of the country strategy with Honduras 2015-2018 (document GN-2796-1), the objectives of which are to: (i) strengthen tax revenue intake; (ii) make public expenditure more efficient; (iii) strengthen transparency mechanisms; and (iv) improve budget management and reduce fiscal contingencies.

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<sup>33</sup> The program includes a component to strengthen macro-fiscal management.

<sup>34</sup> The Bank previously supported investments to improve public expenditure control. This operation envisions specific policy actions to the same end.

<sup>35</sup> As part of the preparation for this operation, preparatory technical assistance was provided to comply with a number of conditionalities in the area of macro-fiscal management, tax expenditure, and PPP- and pension-related contingent liabilities (ATN/OC-14216-HO and ATN/FI-12821-HO).

<sup>36</sup> The policy measures envisaged in this operation are framed within the reforms supported by the IMF program, and they complement the policies supported under the World Bank's program.

- 1.25 Within the framework of the Ninth General Increase in the Resources of the Inter-American Development Bank (document AB-2764) (GCI-9), this program will contribute to the lending priority of support to small and vulnerable countries, as follows: support to Honduras in strengthening tax administration and improving public expenditure efficiency. Similarly, the program will also support the regional target for the ratio of actual to potential tax revenues, as well as the output of the number of public financial systems implemented or upgraded. The project is also aligned with the Sector Strategy for Institutions for Growth and Social Welfare (document GN-2587-2), in that it supports revenue generation, macro-fiscal management, and improved public expenditure management, thus protecting social and growth objectives. In addition, the operation is aligned with the Sector Framework Document—Labor (document GN-2741-3), which proposes to improve the coverage, sustainability, and institutional soundness of pension systems, as well as improving the capacity to control, inspect, and monitor supervision bodies.

**B. Objectives, components, and cost**

- 1.26 The main objective of the program is to support fiscal consolidation in Honduras through policy measures to strengthen macro-fiscal management, increase fiscal revenue collection, enhance public expenditure management, and improve the management of fiscal risks associated with contingent liabilities. The program is structured into two operations using the programmatic policy-based loan modality, subject to the verification of measures to address the challenges mentioned above.
- 1.27 The program will benefit: (i) the Government of Honduras, and especially SEFIN, through improvements across all areas of public financial management, thus supporting consolidation of the public finances; and (ii) the entire Honduran population, by improving efficiency and transparency in public expenditure management, thus generating potential savings and improving the country's fiscal situation. The program consists of the following components:
- 1.28 **Component I. Macroeconomic stability.** The objective of this component is to ensure a macroeconomic context that is consistent with the program objectives set out in the policy matrix for both operations.
- 1.29 **Component II. Strengthening of macro-fiscal management.** The objective is to improve the institutional and management framework for fiscal policy, thus supporting medium-term fiscal equilibrium. To this end, the following actions are proposed: (i) the strengthening of management instruments to create greater predictability in fiscal policy and guide fiscal policy decisions; (ii) modernization of SEFIN's structure, responsibilities, and functions to improve macro-fiscal analysis capacity; and (iii) strengthening of the institutional framework for establishing fiscal discipline.
- 1.30 Under this component, the following conditions have been established for disbursement. First operation: (i) preparation of a medium-term macro-fiscal framework (MTMF), including fiscal targets and a public debt policy that encompasses debt sustainability analysis; (ii) approval of a legal instrument creating a Macro-fiscal Policy Directorate with defined responsibilities; and (iii) drafting of a Fiscal Responsibility and Transparency Law to strengthen fiscal

discipline.<sup>37</sup> Second operation: (i) preparation of a multiyear budget based on MTMF guidelines; (ii) a satisfactory performance evaluation of the macro-fiscal policy directorate; and (iii) promulgation of the Fiscal Responsibility and Transparency Law.

**1.31 Component III. Modernization of tax and customs revenue management.**

The objective is to strengthen management of the tax administration in order to increase collections. To this end, the following actions are proposed: (i) restructuring of tax and customs administration; (ii) improving ISV administration; and (iii) strengthening transparency and controls in the awarding of tax breaks.

1.32 Under this component, the following conditions have been established for disbursement. First operation: (i) approval of executive decrees creating a Revenue Administration Service (SAR) to replace the current Executive Revenue Directorate (DEI); (ii) establishment of the regulatory basis for implementing electronic invoices, allowing more effective control of the ISV and reduced tax evasion; and (iii) consolidation of the list of beneficiaries of tax breaks by category, including the start and end dates of the breaks. Second operation: (i) approval of the executive decrees incorporating customs revenue functions into the SAR; (ii) implementation of electronic invoicing by large taxpayers and authorization of the SAR as a digital signature certification authority; and (iii) a procedure for systematically evaluating the cost of tax breaks.

1.33 **Component IV. Improve public expenditure management.** The objective is to strengthen public expenditure management to make it more efficient and transparent, by (i) improving budget formulation by incorporating medium-term planning; (ii) strengthening payroll controls throughout the central, deconcentrated, and decentralized public administration; (iii) improving transparency in the execution of nonbudgetary expenditure; and (iv) optimization of the public procurement process, with a view to enhancing its efficiency and transparency by using electronically based procedures.

1.34 Under this component, the following conditions have been established for disbursement. First operation: (i) pilot implementation of a medium-term expenditure framework (MTEF) in five entities (based on the MTEF Adoption Manual)<sup>38</sup> and drafting of a multiyear budget for 2016-2019; (ii) the introduction of instruments to improve human resources management, including a directive that all institutions register their employees in the System for the Registration and Supervision of Public Employees (SIREP) and update that registry on a monthly basis in order to receive budget transfers, as well as publication of consolidated

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<sup>37</sup> Support will continue to be provided under ATN/OC-14216-HO for a number of activities involved in preparation of the MTMF. The technical cooperation operation HO-T1232 (currently being prepared) will support: (i) the transition process in the tax administration; (ii) the strengthening of human talent management; and (iii) a public information strategy.

<sup>38</sup> The selected entities are part of the Social Development and Inclusion Cabinet: Health, Education, the National Child Welfare Agency (PANI), National Autonomous Water and Sewerage Service (SANAA), and the National Sustainable Urban and Rural Development Program (PRONADERS). These are the priority sectors under the Government of Honduras's economic and social development policies.



SIREP data,<sup>39</sup> completion of payroll audits in four entities,<sup>40</sup> and the elimination of vacant positions to encourage efficiency; (iii) the creation and implementation of procedures for registering trusts as part of budget formulation;<sup>41</sup> and (iv) approval of five framework agreements making it mandatory for all State entities to purchase their supplies through an electronic catalog within the terms of these agreements. Second operation: (i) institutionalization of MTMF preparation and gradual implementation thereof in all central government entities; (ii) implementation of external payroll audit recommendations, completion of functional audits in at least four institutions prioritized by the government, and institutionalization (through the SIREP) of controls on public sector employment in the central, deconcentrated, and decentralized administration; (iii) institutionalization of budget registration procedures for trusts, publication of a national registry of trusts, and a feasibility study on the trusts in order to eliminate or transform them into budgetary program in the context of the Fiscal Responsibility and Transparency Law; and (iv) framework agreements and online catalogs for eight categories of supplies and joint purchases, as well as the effective use of the framework agreements by more than 50% of public entities.

- 1.35 **Component V. Strengthen management of contingent liabilities.** The objective is to mitigate the fiscal risks linked to PPP- and pension-related contingent liabilities:

**1. Subcomponent 1. Public-private partnerships**

- 1.36 The objectives of this subcomponent are to: (i) improve the approval, monitoring, and control process for PPP projects; and (ii) strengthen management of fiscal risks associated with PPP contingent liabilities. The conditions for disbursement are as follows: First operation: (i) approval of regulations to strengthen the Law to Promote Public-Private Partnerships (2010), the process of registering PPPs in the National Public Investment System (SNIP), and establishment of a timeline for including PPPs in the draft annual budget; and (ii) approval of regulations creating a Fiscal Contingencies Unit (UCF) in SEFIN and improving the coordination of units involved in PPPs.<sup>42</sup> Second operation: (i) 100% of PPP projects are registered in the SNIP and follow the timeline process established in the UCF regulations; and (ii) risk analysis tools are implemented and the UCF evaluates at least 75% of PPP project proposals.

**2. Subcomponent 2. Pensions**

- 1.37 The objectives of this subcomponent are to: (i) improve management of risks associated with pension fund investments; and (ii) strengthen governance of public pension funds as relates to investment decisions. The conditions for disbursement are as follows: First operation: (i) update of the regulatory framework for public pension fund investments to ensure the appropriate

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<sup>39</sup> Including monthly reporting of the total number of employees (permanent and temporary) and total payroll spending in each entity.

<sup>40</sup> The Ministries of Education, Infrastructure and Public Services, Health, and Security (approximately 54% of the total number of employees).

<sup>41</sup> The procedure will be applied in the most representative trusts (op. cit. 24).

<sup>42</sup> Technical support will be provided under ATN/OC-13579-HO for compliance with program conditionalities and activities to strengthen both the launch of this unit and its capacities.

investment of reserves and management of the risks inherent to this activity; and (ii) update of the regulatory framework for corporate governance as relates to investment decisions, with the aim of controlling poor practices that lead to erroneous and costly operational and financial decisions by the public pension funds. Second operation: (i) approval of a regulatory framework for public pension fund investments, accompanied by an implementation plan; and (ii) approval of corporate governance regulations for the public pension funds, accompanied by an implementation plan.

### **C. Key outcome indicators**

- 1.38 To measure the impact and outcomes of the policy and reform actions envisioned under the program, a [results matrix](#) was prepared. These outcomes will be monitored and evaluated in agreement with the borrower.
- 1.39 The expected impact of the program is to reduce the central government fiscal deficit from -4.4% of GDP in 2014 to -2.4% in 2019. The main outcomes are as follows: macro-fiscal management: (i) expand the planning horizon for the fiscal framework from one year to four. Tax and customs revenue management: (i) increase tax collection as a proportion of GDP from 16.3% in 2014 to 17.1% in 2019; and (ii) increase the percentage of large taxpayers using electronic invoices from 0% in 2014 to 40% in 2019. Public expenditure management: (i) reduce central government payroll expenditure as a proportion of GDP from 9.1% in 2014 to 8.6% in 2016; and (ii) increase the percentage of the public sector supplies budget that is executed through framework agreements and electronic catalogs from 0.6% in 2014 to 3.4% in 2017. Management of contingent liabilities: (i) increase the proportion of approved PPP contracts that are registered in the SNIP from 0% to 100% in 2016; and (ii) increase the percentage of new investments made in accordance with the new investment regulatory framework issued by the CNBS from 0% to 100% in 2019.
- 1.40 **Economic rationale.** A comparative analysis of the program's economic/financial costs and benefits was carried out (see [Economic Evaluation](#)). The analysis was based on: (i) a real increase in ISV collection from phasing in electronic invoicing, which will reduce irregularities in the use of fiscal invoices; (ii) cost savings from the audit and optimization of the central government payroll, with the definitive removal of "ghost" employees and employees without specific functions; and (iii) cost savings resulting from the use of framework agreements and electronic catalogs for public procurement, which will facilitate improved planning and price standardization for central government entities.
- 1.41 As this is a policy-based program, investments totaling US\$44.2 million by the Government of Honduras in support of these three measures (using its own resources and investment loans) were taken into account in calculating program benefits. Using a discount rate of 12%, it is estimated that the project will yield an internal rate of return of 40% over the 10-year period to 2025, with a net present value of US\$23.7 million. The envisioned measures are compatible with the targets agreed under the Stand-by Arrangement between the Government of Honduras and the IMF.

## II. FINANCING STRUCTURE AND MAIN RISKS

### A. Financing instruments

- 2.1 This operation has been structured using a programmatic approach (a series of two operations), based on the guidelines and directives laid out in the new lending framework (document GN-2200-13) and the guidelines for the preparation and implementation of policy-based loans (document CS-3633-1). A programmatic approach is justified by: (i) the complex nature of the fiscal consolidation reforms, which require medium-term actions to ensure the sustainability of public finances; (ii) the different timelines for implementing each of these actions; (iii) the adoption of a three-year program with the IMF, which requires technical support to comply with conditionalities; and (iv) support and continuity of the policy dialogue in the country.
- 2.2 The loan is for a total of US\$60 million, consisting of US\$36 million from the Ordinary Capital and US\$24 million from the Fund for Special Operations (FSO). The funds will be disbursed in a single tranche, which is justified by the country's financing requirements to maintain a stable macroeconomic framework. The amount and timing of the second operation will be agreed with the government based on the Bank's programming exercise with the country and progress towards fulfillment of the triggers.

### B. Environmental and social risks

- 2.3 In accordance with Directive B.13 of the Environment and Safeguards Compliance Policy (document GN-2208-20, operational policy OP-703), no classification is required for this operation as it is programmatic in nature.

### C. Fiduciary risks

- 2.4 Fiduciary risk is considered to be low, as this is a budget support program under which funds will be transferred to the general treasury of the Republic of Honduras subject to compliance with the conditionalities established in the [policy matrix](#).

### D. Other project risks

- 2.5 The operation is classified as medium risk. The main risks are as follows:
- a. **Macroeconomic.** Macroeconomic risk is considered to be medium, as weaknesses in economic policy management or external factors (such as natural disasters, changes in coffee and oil prices, and international financial crises) could negatively affect the macroeconomic scenario in Honduras and prevent the attainment of expected levels of fiscal stability. This risk is mitigated by the Government of Honduras's Stand-by Arrangement with the IMF, which supports its economic program to restore fiscal discipline by the end of 2017. Furthermore, this program incorporates measures to promote fiscal stability, such as a Fiscal Responsibility and Transparency Law and actions to control payroll spending.
  - b. **Development**
    - (i) There is a medium level of risk attached to the possibility that technical capacity will be insufficient for the timely development of

technical and legal instruments for fiscal responsibility and transparency, leading to delays in implementing the policy measures aimed at establishing fiscal discipline. This risk will be mitigated by forming a working group composed of two committees (technical and management) of different SEFIN units to coordinate preparation of the Fiscal Responsibility and Transparency Law, with the support of an expert in this area.

- (ii) There is a medium risk that insufficient technical and financial support will lead to delays in implementing tax administration policy measures. This risk will be mitigated by specific activities supported under the investment project to modernize tax administration (3541/BL-HO); these will be implemented in the interval between the two tranches of this operation.
  - (iii) There is a medium risk that institutional weakness in managing the risk of those obligations will lead to delays in implementing the policy measures related to contingent liabilities. This risk will be mitigated through the provision of technical assistance to the UCF (under ATN/OC-13579-HO) to meet PPP-related conditions, and to the CNBS (under ATN/FI-12821-HO) for conditions related to the pension system.
- c. **Governance.** There is a medium risk that tax collections will fall as a result of a reduction in taxpayer perceptions of non-compliance detection risks, stemming from the transition process in the tax administration (i.e. difficulties in simultaneously recruiting and training new staff). This risk will be mitigated through execution of the investment project to modernize tax administration (3541/BL-HO); this envisions a transitional operating plan that includes measures to ensure: (i) compliance with the timelines for employee separation and hiring; and (ii) continuity in the monitoring of large taxpayers and in the international trade procedures carried out by customs.
- d. **Sustainability.** There is a medium risk that fiscal sustainability will not be maintained in the years following the introduction of the policy measures, owing to a failure to adequately implement principles of fiscal responsibility and transparency. This risk will be mitigated by the design and promulgation of a Fiscal Responsibility and Transparency Law with clear sanctions for noncompliance, as well as the adoption of different instruments that will allow a sustainable improvement in public financial management and transparency.
- e. **Implementation.** There is the risk that the program will be affected by: (i) mass labor court challenges or popular protests associated with the separation of DEI staff; or (ii) an inability to attain the fiscal targets agreed in the stand-by arrangement with the IMF (classified as a medium risk). This risk will be mitigated through different actions that address the corresponding political economy considerations: (i) the actions envisioned in the investment project to modernize tax administration (3541/BL-HO), including promoting voluntary retirements before lay-offs, a public information campaign (external

and internal),<sup>43</sup> an ex ante external audit of severance payments, and a strategy of mitigation measures for the vulnerable staff to be separated; and (ii) a number of the measures included in the program and the technical assistance provided during program preparation, both of which support compliance with a number of Stand-by Arrangement conditionalities.

- 2.6 In terms of the sustainability of the measures envisioned in this operation, the program has been designed within the framework of the reform priorities and government plan for 2014-2018, which includes targets for the consolidation of public finances (a reduction in the central government fiscal deficit to 2.5% of GDP at the end of 2017). Policy actions under the program include structural measures that will be difficult to reverse, associated with the Fiscal Responsibility and Transparency Law, reform of the tax administration, and controls on wage spending. These measures will help to bring about a sustainable improvement in the fiscal situation in Honduras.

### III. IMPLEMENTATION AND MANAGEMENT PLAN

#### A. Summary of execution arrangements

- 3.1 The borrower is the Republic of Honduras, and the executing agency for the program will be SEFIN. The latter will coordinate with the DEI (the SAR, once the executive decrees have been issued), the Government General Coordination Department (SCGG), the Regulatory Office for State Procurement (ONCAE), and the CNBS, as necessary. An important aspect in ensuring success in reform implementation is the fact that program coordination will be the responsibility of the Credit and Public Investment Division in SEFIN—the entity that will benefit directly from the loan resources.
- 3.2 The executing agency is responsible for (i) coordinating the different institutions in charge of implementing measures (this will be achieved by means of a management committee made up of representatives named by each of these institutions, who will be responsible for compliance with the conditions relevant to their entities); (ii) monitoring agreed policy conditions and providing evidence of compliance therewith; (iii) preparing necessary reports within the timeframe agreed with the Bank; and (iv) gathering information that will allow program results to be evaluated.
- 3.3 **Special contractual conditions:** The sole disbursement under this operation is contingent upon compliance with the policy reform conditions laid out in the policy matrix (Annex II) and the policy letter, and with the conditions established in the loan contract.

#### B. Summary of results monitoring arrangements

- 3.4 **Monitoring.** A [Monitoring and Evaluation Plan](#) has been prepared to monitor program results. The key parameters used in preparing the plan were as follows: (i) the policy matrix; (ii) the [results matrix](#); and (iii) the [means of verification matrix](#). SEFIN and the Bank will meet periodically to monitor the results of the

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<sup>43</sup> Stakeholders will be mapped, to identify relevant strategic partners in implementing the tax administration reform and the communication campaign thereon.

operation, as well as to anticipate and resolve any technical difficulties in its execution. SEFIN will submit all necessary information to the Bank to assess compliance with program conditions, and it will provide timely information regarding progress in this respect.

- 3.5 **Evaluation.** Evaluation will be based on the measurement of outcomes using reflexive and financial/economic evaluation methodologies (ex post) (Monitoring and Evaluation Plan). The program will be evaluated with reference to the annual targets and indicators for the outputs and outcomes included in the program's results framework.

#### **IV. POLICY LETTER**

- 4.1 The [policy letter](#) reiterates the central government's commitment to the objectives and actions contemplated under this series of programmatic operations. The Bank and the Government of Honduras have also agreed on a policy matrix that describes policy actions under this programmatic operation, as well as prior actions for disbursement under the second operation.

Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program		-Lending to small and vulnerable countries		
Regional Development Goals		-Ratio of actual to potential tax revenue		
Bank Output Contribution (as defined in Results Framework of IDB-9)		-Public financial systems implemented or upgraded (budget, treasury, accounting, debt, and revenues)		
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix		GN-2796-1		
Country Program Results Matrix		GN-2805	The intervention is included in the 2015 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Evaluable	Weight	Maximum Score
		8.6		10
3. Evidence-based Assessment & Solution		9.4	33.33%	10
3.1 Program Diagnosis		2.4		
3.2 Proposed Interventions or Solutions		4.0		
3.3 Results Matrix Quality		3.0		
4. Ex ante Economic Analysis		10.0	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0		
4.2 Identified and Quantified Benefits		1.5		
4.3 Identified and Quantified Costs		1.5		
4.4 Reasonable Assumptions		1.5		
4.5 Sensitivity Analysis		1.5		
5. Monitoring and Evaluation		6.5	33.33%	10
5.1 Monitoring Mechanisms		1.5		
5.2 Evaluation Plan		5.0		
III. Risks & Mitigation Monitoring Matrix				
Overall risks rate = magnitude of risks*likelihood		Medium		
Identified risks have been rated for magnitude and likelihood		Yes		
Mitigation measures have been identified for major risks		Yes		
Mitigation measures have indicators for tracking their implementation		Yes		
Environmental & social risk classification		B.13		
IV. IDB's Role - Additionality				
The project relies on the use of country systems				
Fiduciary (VPC/FMP Criteria)				
Non-Fiduciary				
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor				
Environment				
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project				
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan				

The diagnosis is clear. Honduras faces a complex macroeconomic context in which the main challenge is to restore macroeconomic stability and to consolidate public finance targets in the context of an IMF program. Achieving these goals is contingent on overcoming the main challenges associated with macro-fiscal management, tax administration modernization, improving the efficiency and transparency of public spending and mitigating the risks associated with contingent liabilities. In each of these areas a complete taxonomy of problems and their causes is presented, which leads to a program that addresses short and medium term key fiscal consolidation challenges. The proposed program is composed of five components. The diagnosis and the challenges are clearly articulated.

The vertical logic of the project associates a set of policy measures (products) with a set of associated results, such as an increased planning horizon of the fiscal framework, increased tax burden, increased use of electronic invoicing, among others. All of these results contribute to a reduced Central Government fiscal deficit in relation to Gross Domestic Product (impact).

The economic analysis provides estimates of savings and tax revenue generation in three areas: electronic invoices, public procurement modernization, and public payroll optimization. The Monitoring and Evaluation Plan is complete and an ex post cost-benefit evaluation is proposed.

## POLICY MATRIX

Objective	Policy actions	Triggers for the second programmatic loan
<b>Component I – Macroeconomic stability</b>		
Maintain a stable macroeconomic framework to support the process of fiscal consolidation in Honduras.	Maintain a macroeconomic policy framework that is consistent with program objectives and the guidelines set out in the policy letter.	1.1 Maintain a macroeconomic policy framework that is consistent with program objectives and the guidelines set out in the policy letter.
<b>Component II – Strengthening of macro-fiscal management</b>		
Improve the institutional and management framework for fiscal policy, thus supporting medium-term fiscal equilibrium.	2.1 Strengthen instruments to create greater predictability in fiscal policy and guide fiscal policy decisions, through preparation of a Medium-term Macro-fiscal Framework (MTMF), including fiscal targets and a public debt policy that encompasses debt sustainability analysis.	2.1 Drafting of the 2017 Budget, containing the Medium-term Spending Framework 2017-2020, prepared in accordance with the guidelines in the 2017-2020 MTMF.  Responsible party: Ministry of Finance (SEFIN)
	2.2 Modernize SEFIN's structure, responsibilities, and functions to improve macro-fiscal analysis capacity, through the creation of a Directorate of Macro-Fiscal Policy.	2.2 Conduct a performance evaluation of the Macro-fiscal Policy Directorate, demonstrating that the unit is meeting its objectives and has reached the annual targets agreed in its work plan.  Responsible party: SEFIN
	2.3 Strengthen the institutional framework for fiscal discipline by drafting a Fiscal Responsibility and Transparency Law.	2.3 Fiscal Responsibility and Transparency Law promulgated and published in the Gazette.  Responsible party: Executive branch and SEFIN
<b>Component III – Modernization of tax and customs revenue management</b>		
Strengthen tax management to increase collections	3.1 Strengthen the management of tax and customs administration by replacing the current Executive Revenue Directorate (DEI) with a new Revenue Administration Service (SAR).	3.1 Publication in the Gazette of executive decrees eliminating the Deputy Directorate for Customs Revenue (DARA) and incorporating trade control functions into the SAR.  Responsible party: Executive Branch
	3.2 Improved management of the sales tax (ISV) by creating the regulatory basis for the implementation of electronic invoicing, with a view to more effectively enforcing this tax and reducing tax evasion.	3.2 (a) Implementation of electronic invoicing by 30 of the most representative large taxpayers. (b) Intellectual Property Institution resolution authorizing the SAR as a signature certification authority.  Responsible party: SAR



Objective	Policy actions	Triggers for the second programmatic loan
	3.3 Strengthen transparency and controls in the awarding of tax breaks by consolidating the list of beneficiaries and creating procedures for the systematic evaluation of the cost of such breaks.	3.3. (a) Introduction of procedures for the systematic evaluation of the cost of tax breaks. (b) Tax breaks report included in the supporting documentation for the 2017 budget.  Responsible party: SEFIN and SAR
<b>Component IV – Improve public expenditure management</b>		
Strengthen public expenditure management to make it more efficient and transparent.	4.1 Strengthen budget formulation by implementing a Medium-term Expenditure Framework (MTEF) in pilot entities <sup>1</sup> and prepare a multiyear budget for 2016-2019.	4.1 (a) Organic Budget Law reviewed and submitted to the National Congress, to institutionalize preparation of the MTEF. (b) MTEF gradually implemented in all central government entities.  Responsible party: SEFIN
	4.2 Strengthen payroll controls throughout the central, deconcentrated, and decentralized public administration by improving human resources management through the introduction of instruments to give effect to the reforms mandated under Executive Decree PCM-028-2014, which created the Commission to Reform the Central Government and Decentralized Institutions. This will include:  (a) A directive that all institutions register their employees in the System for the Registration and Supervision of Public Employees (SIREP) and update that registry by reporting increases and reductions in employment to SEFIN on a monthly basis in order to receive budget transfers. (b) Publication of consolidated SIREP data, including monthly reporting of the total number of employees (permanent and temporary) and total payroll spending in each entity. (c) Completion of external payroll audits in the Ministries of Education, Infrastructure and Public Services, Health, and Security (approximately 54% of the total number of employees), with findings and recommendations for eliminating detected irregularities.	4.2. (a) Specific recommendations in the external payroll audits in Education, Infrastructure and Public Services, Health, and Security are implemented. (b) Functional audits completed in four priority institutions (Ministries of Education, Health, Security, and Infrastructure and Public Services). (c) Institutionalization, through the SIREP, of public employment supervision throughout the central, deconcentrated, and decentralized public administration.  Responsible party: Government General Coordination Department (SCGG) and SEFIN

<sup>1</sup> The MTEF Adoption Manual will be used as a guide to implementation.

Objective	Policy actions	Triggers for the second programmatic loan
	(d) The elimination of vacant positions and jobs to encourage efficiency.	
	4.3 Improve transparency in the use of trusts in public expenditure through the creation and implementation of procedures for registering the trusts as part of budget formulation.	<p>4.3</p> <p>(a) Budget registration procedures for most of the trusts institutionalized in the general provisions of the 2016 budget.</p> <p>(b) Publication of a national registry of trusts and preparation of a feasibility study for the trusts in the context of the Fiscal Responsibility and Transparency Law, with a view to gradually eliminating or transforming them into budgetary programs.</p> <p>Responsible party: SEFIN</p>
	<p>4.4 Optimization of the public procurement process with a view to enhancing its efficiency and transparency by using more transparent, electronically based procedures, with the introduction of instruments that give effect to the reforms mandated under Legislative Decree 36-2013, and under the Law for Efficient and Transparent Procurement using Electronic Means (August 2014) and its regulations (Executive Agreement 00641-2014, October 2014). This will include:</p> <p>(a) Approval of five framework agreements making it mandatory for State entities to purchase all supplies through an electronic catalog within the terms of these agreements, and its effective use by public sector institutions.</p>	<p>4.4</p> <p>(a) Framework agreements opened to bidding and adjudicated, with online catalogs for eight categories of supplies and joint purchases.</p> <p>(b) Use of the framework agreements for supply purchasing by more than 50% of central and decentralized government entities.</p> <p>Responsible party: SCGG and the Regulatory Office for State Procurement (ONCAE)</p>
<b>Component V – Strengthen management of contingent liabilities</b>		
<b>Subcomponent 1: Public-private partnerships</b>		
Mitigate fiscal risks linked to contingent liabilities related to public-private partnerships (PPPs)	<p>5.1 Improve the approval, monitoring, and control process for PPP projects and strengthen management of fiscal risks associated with PPP contingent liabilities, by:</p> <p>(a) Strengthening the Law to Promote Public-private Partnerships.</p> <p>(b) Improving the process of registering PPPs in the National Public Investment System (SNIP) and establishing a timeline for including PPPs in the draft annual budget.</p>	<p>5.1</p> <p>(a) 100% of PPP projects registered in the SNIP, with a corresponding prefeasibility study.</p> <p>(b) 100% of PPPs included in the annual budget complied with the timeline process stipulated in the regulation.</p> <p>Responsible party: SEFIN</p>

Objective	Policy actions	Triggers for the second programmatic loan
	5.2 Strengthen the management of fiscal risks associated with PPP-related contingent liabilities by approving regulations to create a specialized technical unit (the Fiscal Contingencies Unit, UCF) in SEFIN, and by improving the coordination of units involved in PPPs.	5.2 (a) Risk analysis tools implemented. (b) Evaluation by the UCF of at least 75% of PPP project proposals to determine their feasibility and relevance in the annual budget. Responsible party: SEFIN
<b>Subcomponent 2: Pensions</b>		
Mitigate fiscal risks linked to pension-related contingent liabilities	5.3 Strengthen management of the risks associated with pension fund investments by updating the regulatory framework governing public pension fund investments.	5.3 (a) Investment regulation for public pension funds approved. (b) Implementation plan for the investment regulation for public pension funds.  Responsible party: The Superintendency of Pensions, Securities, and Other Institutions, and the National Banking and Insurance Commission (CNBS)
	5.4 Strengthen the governance of public pension funds by updating the regulatory framework for corporate governance as relates to investment decisions, with the aim of controlling poor practices that lead to erroneous and costly operational and financial decisions by the public pension funds.	5.4 (a) Corporate governance regulations for public pension funds approved. (b) Implementation plan for the corporate governance regulations for public pension funds.  Responsible party: The Superintendency of Pensions, Securities, and Other Institutions, and the CNBS

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-\_\_\_/15

Honduras. Loan \_\_\_\_/BL-HO to the Republic of Honduras  
Fiscal Consolidation Support Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting a financing to cooperate in the execution of the fiscal consolidation support program. Such financing will be for the amount of up to US\$36,000,000 from the resources of the Single Currency Facility of the Bank's Ordinary Capital, corresponds to a parallel loan within the framework of the multilateral debt relief and concessional finance reform of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on \_\_\_\_ 2015)

LEG/SGO/CID/IDBDOCS#39914453  
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RESOLVES:

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(Adopted on \_\_ \_\_\_\_\_ 2015)

LEG/SGO/CID/IDBDOCS#39914511  
HO-L1103