

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

SUPPORT PROGRAM FOR REFORM OF PENSION INSTITUTIONS AND THE HUMAN RESOURCES MANAGEMENT SYSTEM

(HO-L1079)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Waldo Tapia (SCL/LMK), Project Team Leader; Belinda Pérez Rincón (FMM/CHO), Alternate Project Team Leader; Roberto Flores-Lima (SCL/LMK); David Kaplan (SCL/LMK); Héctor Salazar (SCL/SCL); Cristina Fernández (CID/CID); Nalda Morales (PDP/CHO); Ethel Muhlstein (SCL/LMK); Eduardo Fernández Maldonado (SCL/LMK); and Mónica Lugo (LEG/SGO).

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ELECTRONIC LINKS	
REQUIRED	
1.	Policy letter http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36500724
2.	Means of verification http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36358600
3.	Results Matrix http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36361696
OPTIONAL	
1.	Monitoring and evaluation plan http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36415831
2.	Economic analysis http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36418568

ABBREVIATIONS

CNBS	Comisión Nacional de Bancos y Seguros [National Commission of Banks and Insurers]
DOD	Pension system covering disability, old age, and death caused by accident or common illness
IHSS	Instituto Hondureño de Seguridad Social [Honduran Social Security Institute]
ILO	International Labour Organization
IMF	International Monetary Fund
INJUPEMP	Instituto Nacional de Jubilaciones y Pensiones de los Empleados y Funcionarios del Poder Ejecutivo [National Institute of Retirement and Pensions for Public Officials and Government Employees]
INPREMA	Instituto Nacional de Previsión del Magisterio [National Pension Institute for Teachers]
INPREUNAH	Instituto de Previsión de la Universidad Nacional Autónoma de Honduras [Pension Institute of the National Autonomous University of Honduras]
IPM	Instituto de Previsión Militar [Military Pension Institute]
SEFIN	Ministry of Finance
SIAFI	Sistema de Administración Financiera Integrado [Integrated financial management system]

PROJECT SUMMARY

HONDURAS

SUPPORT PROGRAM FOR REFORM OF PENSION INSTITUTIONS AND THE HUMAN RESOURCES MANAGEMENT SYSTEM (HO-L1079)

Financial Terms and Conditions				
Borrower: Republic of Honduras			OC	FSO
Executing agency: Ministry of Finance (SEFIN)		Amortization period:	30 years	40 years
Source	Amount	Grace period:	5.5 years	40 years
IDB (Ordinary Capital)	US\$28,000,000	Disbursement period:	12 months	12 months
IDB (FSO)	US\$12,000,000	Inspection and supervision fee:	*	0
Other/Cofinancing	0	Interest rate	Single Currency Facility-Fixed	0.25%
Local	0	Credit fee:	*	0
Total	US\$40,000,000	Currency:	U.S. dollars	U.S. dollars
Project at a Glance				
Project objective/description: The general objective of the program is to help the country's macroeconomic and fiscal stability take root through reforms that promote the long-term sustainability of pension institutions and control over unplanned growth of government employee salaries. The specific objectives are to support efforts by the Government of Honduras to reform its pension institutions and to introduce improvements in systems for administrative and budgetary control over the central government's human resources so as to lay the groundwork for building a more equitable and sustainable pension system and for improving human resources management in the central government. The program will be structured in three components: (i) macroeconomic stability; (ii) pension institution reform; and (iii) improvement in management of the central government's human resources.				
Special contractual conditions: A condition precedent to disbursement of the single tranche of the programmatic loan is fulfillment to the Bank's satisfaction of the policy conditions set forth in Annex II (Policy Matrix), in addition to fulfillment of the other conditions stipulated in the loan contract.				
Exceptions to Bank policies: None				
Project qualifies as: SEQ [] PTI [] Sector [] Geographic [] Headcount []				

* 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. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

- 1.1 **Macroeconomic and fiscal conditions.** The Honduran economy has been characterized by an export sector targeting primarily the U.S. market, a high level of petroleum imports, and a significant flow of income in the form of remittances and foreign aid. As a result, the country was highly sensitive to the effects of the financial crisis, a factor that was worsened by the political crisis culminating in 2009. The political crisis interrupted the flow of external financing to the country, which, in the context of unbudgeted expenditures and a significant increase in the total wage bill, required an increase in internal debt under unfavorable conditions. That year, economic growth fell from 4% to 1.9%, remittances decreased by 12.3%, and the consolidated public sector deficit rose by 4.6%. The Honduras National Statistics Institute estimates that the number of poor households went up by 5% between May 2009 and May 2010.
- 1.2 The Honduran Administration that took office in January 2010 has made significant efforts toward achieving political reconciliation and the country's full reintegration into the international community. In the economic sphere, along with the end to the interruption in external financing, headway was made in the following areas: (i) the fiscal reform of April 2010, including tax reform, an increase in public utility rates, and more efficient spending; and (ii) signature of a stand-by arrangement with the International Monetary Fund (IMF).¹
- 1.3 This strategy was reflected in an improvement in the country's economic indicators. In fact, following the 1.9% decrease in gross domestic product (GDP) in 2009, growth of 2.8% was achieved in 2010. Likewise, the public sector ended 2010 with a 2.8% deficit in GDP, which was lower than the originally projected 3.7%. The external sector presented a current account deficit of 6.2% of GDP, which was financed with foreign direct investment (5% of GDP) and external debt (3% of GDP). Inflation was 6.5% at the end of 2010.
- 1.4 The outlook for 2011 is also positive. Projections include growth of 3.5%, inflation of 8% (+/- one percentage point), and a consolidated public sector deficit of 3.5%² of GDP. The country's gross financing needs are estimated at US\$1.198 billion for 2011. A current account deficit of 6.9% of GDP is projected for the external sector, which will continue to be largely financed by capital inflows, resulting in a stock of international reserves equivalent to four months of imports. Lastly, the exchange rate is expected to be very similar to the rate observed, despite reinstatement of the exchange-rate band.³

¹ <http://www.imf.org/external/pubs/ft/scr/2011/cr11101.pdf>

² 3.9% in the most recent SEFIN estimate. Fiscal Outlook 2011.

³ The Central Bank has tightened the currency supply to avoid an overreaction of the exchange rate.

Table 1: Macroeconomic parameters and financing needs 2010-2011

	2010	2011
Macroeconomic parameters		
GDP	2.8	3.5
Consumer price index	6.5	8(+/-)1
Current account deficit	(6.2)	(6.9)
International reserves	4.0	4.0
Fiscal balance calculated (% of GDP)		
GDP growth rate	2.8	3.5
Tax revenues	15.5	16.0
Primary expenditure	26.8	24.9
Primary balance of the combined public sector	(2.0)	(1.8)
Overall balance of the combined public sector	(2.9)	(3.5)
Financing calculated (millions of U.S. dollars)		
Gross financing needs	981	1,198
Overall combined public sector deficit	448	516
Amortizations	553	681

Source: IMF and SEFIN

- 1.5 For 2012, the Government of Honduras has indicated that it will deepen its efforts at fiscal fine-tuning and strengthening, anticipating an even greater reduction in the deficit, while setting a target for the consolidated public sector deficit of 2.2% of GDP. However, achievement of that target is threatened in the short term by the liquidity problems of social security institutions and by pressures for wage increases for central government employees.⁴
- 1.6 **Status of pension institutions.**⁵ The pension system in Honduras consists of the Honduran Social Security Institute (IHSS) and the four pension institutions corresponding to the trade unions with the greatest capacity for organization: the National Pension Institute for Teachers (INPREMA), National Institute of Retirement and Pensions for Public Officials and Government Employees (INJUPEMP), Military Pension Institute (IPM), and the Pension Institute of the National Autonomous University of Honduras (INPREUNAH). Table 2 provides a detailed comparison of the main characteristics of the five pension institutions,

⁴ Other structural risks include dependence on the price of oil and on the U.S. economy, the increase in illegal activities, and the country's high level of vulnerability to natural disasters, which are analyzed in the independent macroeconomic assessment.

⁵ The major pension reforms introduced in the region have mainly been in the form of changes to the parameters of pension models or structural reforms. Since then, 11 Latin American countries have privatized part of their social security systems. In contrast, Brazil and most countries in Central America and the Caribbean have elected to strengthen the public pension system. Those countries have introduced reforms mainly geared toward better alignment of contributions and benefits. For more information see "A Quarter Century of Pension Reform in Latin America and the Caribbean: Lessons Learned and Next Steps" (see www.iadb.org/IDBDocs.cfm?docnum=657156).

reflecting the existing disparity in parameters relating to requirements, contributions, and benefits.

Table 2: Main characteristics of the five pension institutions

	IHSS	INPREMA	INPREUNAH	INJUPEMP	IPM
Number of contributors	496,000	70,906	6,519	51,663	20,745
Number of retirees	22,000	13,987	589	9,617	2,710
Minimum retirement age (voluntary)	65 m. / 60 f.	50 years	58 years	58 years	50/58 ⁶
Maximum retirement age (mandatory)	N/A	60	70	65	N/A
Minimum contribution period	15 years	10 years	25 years	10 years	25 years
Contribution rate (% of base salary)	3.5%	19% ⁷	19%	18%	24%
Average monthly salary for calculating pension	Last 180 months' pay	Last 36 months' pay	Last 36 months' pay	Last 36 months' pay	Last 60 months' pay
Number of contributions each year / benefits paid each year	12 / 14	12 / 14	13 / 14	12 / 14	13 / 14

1.7 INPREMA and INJUPEMP present a divergence in terms of the levels of inflows and outflows from the fund, especially when considering that participants have a short mandatory contribution period (10 years) and a young retirement age (50 years for INPREMA and 58 years for INJUPEMP). This situation, combined with a rapid demographic transition, expansion of benefits without the corresponding financing, low return on equity reserves, and high administrative costs, has resulted in the financial inability of the institutions to pay out benefits to all of their participants.

1.8 **INPREMA.** INPREMA was created through Decree 1065 of 15 July 1980 as a social security institution for teachers in the public and private sector. It is an autonomous public law institution with independent legal status, equity capital, and an undefined duration.

⁶ Fifty years for those engaged in high-risk activities (military, police, and firefighters) and 58 years for civil servants.

⁷ Private school teachers 18%.

- 1.9 INPREMA did not exhibit significant financial difficulties in its early years thanks to a young and growing population in which a ratio was maintained of more than 20 contributors for every one pensioner. However, as INPREMA has moved into more advanced stages of its demographic transition, that ratio has deteriorated to the point that there are currently five contributing employees for every one pensioner, and is expected to fall to just 3:1 in the next 10 years.⁸ This puts the institution in an increasingly critical situation, since each new participant creates pension obligations that are much greater than the total contributions from the new participant.
- 1.10 Moreover, the sustainability and solvency of INPREMA have weakened due to the inclusion of new benefits for participants that were not considered in the system's original design and have not been accompanied by increases in the respective employer or employee contribution rates so as to maintain the balance of equity reserves. For example, payments of a thirteenth (Decree 179-97) and fourteenth (Decree 54-95) month of salary are being made to retirees and pensioners in general, resulting in an additional pension payment in June and December of each year. This situation has created a significant technical imbalance for the institution since each participant is only required to contribute 12 times a year, but receives 14 months of pension benefits annually. This represents an annual increase of 17% in the pension budget in perpetuity, above the amount originally established in the INPREMA Law. In addition, the Teachers' Statute establishes a structure for salary increases in the final years of the contribution period, which implies a disproportionate increase in the amount of the pension to be paid, particularly for participants who have retired since 1998 (Decree 136-97).⁹
- 1.11 This situation is worsening considerably due to the weakness of INPREMA's corporate governance, which leads to: high administrative costs and poor financial decisions; lack of effective regulations and internal processes for proper payment of benefits and delivery of services to participants; low real return on equity reserves; high rates of default on its portfolio of personal loans and mortgage loans;¹⁰ and the lack of effective accounting systems allowing the production of auditable reports and financial statements in accordance with international best practices. In addition, government supervisory agencies and regulators do not have the authority to impose sanctions if their regulations are violated.

⁸ National Commission of Banks and Insurers (CNBS) (2010).

⁹ For example, Article 52 of the Teachers' Statute indicates that teachers will be granted a years-of-service increase calculated automatically on the base salary using the following scale: 5 years, 15%; 10 years, 30%; 15 years, 45%; 18 years, 60%; 21 years, 75%; 24 years, 75%; 24 years, 90%; 27 years, 105%; and 30 years, 120%. Since enactment of the Teachers' Statute in 2008, primary teachers have nearly quadrupled their base monthly salary (from US\$190 to US\$741). Wage adjustments for teachers are pegged to adjustments mandated by the Minimum Wage Act.

¹⁰ First Report from the Audit Commission of INPREMA, June 2011.

- 1.12 In this context, CNBS¹¹ performed an actuarial study that determined a shortfall in INPREMA's technical reserve with a present value of more than 79 billion lempiras (US\$4.16 billion), which is approximately 27% of the GDP in 2010. The study also determined that current reserves do not ensure the payment of pensions to current pensioners since the present value of the institution's obligations for benefits granted is on the order of 21.717 billion lempiras (US\$1.145 billion), a figure that far surpasses INPREMA's total current reserves in the amount of approximately 17.234 billion lempiras (US\$910 million). This shortfall means that INPREMA's net equity will be depleted by 2023.
- 1.13 This is not just a long-term problem for INPREMA. The national finances could also be significantly affected in the short and medium term due to a liquidity problem. A large part of INPREMA's equity is held in loans to its participants (close to 65%), certificates of deposits from the financial sector (5%), and government bonds that are not redeemable in the short term (20%). The institution has been using its liquid reserves at a rapid pace, and if the disparity between contributions and benefits is not corrected, it could potentially have to redeem its financial sector and government bonds. If INPREMA does not recover its investments, the government would have to assume those obligations. The pace of these events would accelerate if the nearly 10,000 participants who fulfill the requirements for voluntary retirement exercise their right to a pension.
- 1.14 If the government assumes INPREMA's debt, contingent liabilities estimated at 27% of GDP would become real in 2013, such that the value of the public debt as a percentage of GDP would increase from 19% in the base scenario to 44% in 2031. In the same way, the value of the public debt over revenue would increase from 85% to 195%, and debt service would increase from 14% to 37% of revenue.¹²
- 1.15 In this context, it is urgent that major parametric and administrative reforms be made in INPREMA to correct the problems identified and restore the institution's financial and actuarial capacity. Notable in this regard are reforms to the parametric variables of age and minimum contribution period required to achieve the actuarial balance between amounts contributed and pensions received; changes in the corporate governance structure to improve the professional quality of the human resources who lead and manage the institution; and the financial alignment of contributions made with benefits received.
- 1.16 **INJUPEMP.** This institution was created through Decree 138 of 5 February 1971. Since that date, public officials and government employees have been covered. However, the system did not start operations until 1 January 1976 when contributions were first made.
- 1.17 INJUPEMP's financial-actuarial problems are similar to those of INPREMA, but are more long term, given that contributions to be received in the short and medium

¹¹ INPREMA Actuarial Study, December 2010.

¹² For further details, see Economic Analysis.

term are expected to generate temporary growth in equity reserves. An actuarial study conducted by CNBS determined a shortfall in INJUPEMP's technical reserves equivalent to a present value of 32 billion lempiras (US\$1.685 billion), or 12% of GDP in 2009. In the long term, this situation would result in a financial inability to pay the established benefits, which could result in depletion of net equity by 2030. Thus, it is also necessary to approve a reform to permit elimination of the current actuarial deficit and to restore the institution's financial capacity.

- 1.18 **Honduran Social Security Institute (IHSS).** The IHSS was created in 1959 with the constitutional mandate to guaranty social security in: (i) the health system, which covers sickness, non-work-related accidents, and maternity, and started operations in 1962; and (ii) the pension system, introduced in 1969, which covers disability, old age, and death caused by accident or common illness. An additional system was established in 2005 to cover professional risks, such as permanent disability and death resulting from work-related accidents and illnesses. The Honduran social security system currently has significant gaps in terms of coverage, benefits, and management problems.
- 1.19 The IHSS was created as a mandatory public service¹³ for all public and private salaried employees.¹⁴ The estimated effective coverage of the IHSS is 42.7% of the total number of salaried employees. However, based on the economically active population, the effective coverage of the IHSS averages 18.9% for the period 2000-2009, which is below the minimum effective coverage established in international conventions;¹⁵ by income level, less than 2% of the poorest quintile is covered by the system, while less than 20% of the middle income population (quintiles 2 and 3) have coverage. Coverage in urban areas is an average of 4.6 times higher than in rural areas. Of self-employed workers, 1.2% are covered, versus 36% of private workers, and over 77% of public sector workers.¹⁶ With the exception of the public sector, in none of the cases analyzed—including more formal activities—are coverage rates considered to be satisfactory.
- 1.20 Table 3 shows the contribution rates for all of the IHSS systems, which in early 2011 were applied to a salary ceiling for contributions of 4,800 lempiras (US\$254),

¹³ The law stipulates that the social security system is mandatory for all salaried employees. Independent workers or those who are self-employed; those who are no longer insured but opt to voluntarily continue in the system; in-home workers; and occasional or temporary workers in urban and rural areas are subject to special progressive participation systems.

¹⁴ With the appearance of the pension institutions created by trade unions (see paragraph 1.7), the IHSS ceased to provide disability, old age, and death coverage for most government employees, although it continued providing health services, except to members of the armed forces, police, and firefighters.

¹⁵ Convention 128-130 of the International Labour Organization (ILO) related to invalidity, old-age, and survivors' benefits stipulates that the effective minimum coverage of contributors of the pension system should be equivalent to at least 20% of the economically active population.

¹⁶ See Arenas, Alberto. "Análisis y caracterización de la cobertura del sistema de pensiones de Honduras" ["Analysis and characterization of pension system coverage in Honduras"], 2011.

an amount that was below the minimum monthly wage of 5,886 lempiras (US\$441). In the pension system, although the legal replacement rates range between a minimum of 50% and a maximum of 80% of the base monthly salary, those percentages are applied to a salary ceiling for contributions of 4,800 lempiras (US\$254). This policy has resulted in sharply reduced pensions; for 2009, the average pension for disability and old age ranged between 36% and 37%, respectively, of the minimum monthly salary.¹⁷

Table 3: Contribution rates for the SM, DOD, and PR systems

CONTRIBUTION RATE	SM	DOD	PR	Total
Employer	5.0%	2.0%	0.2%	7.2%
Worker	2.5%	1.0%	0.0%	3.5%
Total	7.5%	3.0%	0.2%	10.7%

SM: Health system covering sickness, non-work-related accidents, and maternity. DOD: Pension system covering disability, old age, and death caused by accident or common illness. PR: System covering professional risks.

- 1.21 The low effective replacement rate and the small number of pensioners with respect to the number of active contributors¹⁸ give the DOD relatively low costs and a comfortable financial position. However, the actuarial status of the DOD system is uncertain. There is no reliable database with the history of contributions and wages of participants, which makes it impossible to estimate the system's long-term obligations and represents a risk for the IHSS. Actuarial studies indicate that in order to improve benefits and expand coverage, it is necessary to adjust—on a step basis over the long term—the current contribution rate from 3% to 8%, adopt a policy for increasing the salary ceiling for contributions, improve the real percentage return on investments, and introduce administrative improvements.¹⁹
- 1.22 The system covering sickness, non-work-related accidents, and maternity has been characterized as a model of curative care with serious administrative weaknesses, which added to a problem of cross subsidies with the Ministry of Health, has helped increase inefficiencies in service delivery. The model adopted (curative rather than preventive) has an impact on the burden of sickness events, which affects the actuarial cost of the system. Geographic coverage is partial, with no presence in three of the four poorest departments in the country. In 2010, more than 600,000 workers were contributing to the system covering sickness, non-work-related accidents, and maternity, while the beneficiary population exceeded one million people, which coupled with the low level of income received from contributions, has weakened the system's financial position.

¹⁷ ILO. Actuarial Valuation of IHSS as of December 2009 (2010).

¹⁸ According to an IHSS report, for 2010 the support ratio (number of active contributors / number of pensioners) was 23.4 active contributors for every one pensioner.

¹⁹ ILO. Idem footnote 17. The actuarial study scenarios indicate that the increase in the salary ceiling for contributions is the parameter with the greatest impact on improving revenue streams.

- 1.23 As a result of administrative and operations management problems in the IHSS, in the last three years the payroll (particularly of administrative personnel) has grown by 35%, while participation has only risen 10%. Thus, personnel expenses represent 57% of the institution's budget (2011).²⁰ The institution does not have a financial and accounting system that is reliable and integrated with service delivery. There are also no support systems for medical services, such as management of clinical histories; consultations, surgeries, and hospitalization; and planning and supply of medications that increases the transparency and quality of services. The IHSS also lacks updated information on its participants, employers, and workers, resulting in weak management of collection of contributions and a high degree of evasion, while the physical infrastructure and equipment deteriorate due to lack of maintenance.
- 1.24 In this context, short-term measures need to be taken to improve the institution's financial position. In the medium term, it is necessary to promote reforms geared toward reestablishing the institution's financial and actuarial viability and to take policy measures aimed at expanding the system's coverage, especially among the most vulnerable population. In the case of the DOD system, the young demographic or support ratio²¹ represents a window of opportunity to make the necessary reforms due to the low level of obligations of the pension system and the possibility of expanding its coverage.
- 1.25 **Status of human resources management.** There are 120,000 central government employees, of which 18.5% are subject to the Civil Service Law; 52.7% are subject to Professional Statutes; and the remaining 28.8% are governed by specific regulations.²² In addition, employees in the decentralized sector, i.e. institutions with legal status and equity capital (32,250 people) are subject to the Labor Code. The Teachers' Statute covers 59,000 teachers, which represent 50% of the central government employee payroll. Teaching is the sector that puts the most pressure on public finances due to the number of teachers and the fact that the Teachers' Statute calls for salary adjustments irrespective of actual macrofiscal conditions.²³ In 2010, spending on compensation for central government employees represented 74% of tax revenues, 60% of current expenditure, and 50% of total spending (2011 IMF).²⁴ The range of regulatory frameworks for government employees has also led to different payroll management systems and makes it difficult to apply transparent selection, hiring, and promotion processes for personnel. This situation threatens

²⁰ There are estimated to be 1,200 contract employees dedicated to work unrelated to medical-hospital services who have acquired labor rights for approximately 200 million lempiras (US\$10 million) due to contract continuity.

²¹ See footnote 18.

²² Including employees of National Security and Defense and the Revenue Service.

²³ See footnote 9.

²⁴ The highest level in the region. See Díaz, Magín. "El Gasto Público en Honduras: Ajuste y Desafíos Macro-Fiscales" ["Public Spending in Honduras: Macroeconomic Adjustment and Challenges"], 2010.

- the balance of fiscal accounts, limits the budget headroom of the Government of Honduras for implementing policies and making investments, and reduces capacity for applying performance standards²⁵ and improving the management and quality of the public administration.
- 1.26 Given this situation, an agency needs to be established that will permit advances in centralized control over the central government employee payrolls and progress toward a teacher human resources management system that is integrated with the financial management system of the Government of Honduras. Moreover, progress needs to be made toward a new structure for wage increases for government employees, particularly teachers, that is aligned with the Honduran government's available fiscal resources.
- 1.27 **Bank strategy with the country and the sector.** The program is consistent with the Bank's Strategy with Honduras 2007-2010. Given their fiscal effects, pension institution reforms are essential to improving public resource management in order to optimize institutional performance while at the same time strengthening and expanding the country's fiscal structure. These efforts fall under one of the priority areas of the Bank's strategy with Honduras: improve the investment climate. In addition, the program supports the Bank's strategic objective of addressing the needs of the small and least developed countries and it dovetails with sector priorities related to: (i) social policy promoting equality and productivity through measures aimed at sustainable social security coverage; and (ii) institutions for growth and social welfare through the strengthening of public spending management systems.
- 1.28 **Strategy of the program.** In the framework of the Country Vision 2010-2038, the Government of Honduras has proposed the long-term objective of strengthening an inclusive and efficient social security system that ensures better conditions for workers. With the objective of modernizing the State to make it more responsible, efficient, and competitive, the Honduran government has committed to introducing improvements in public management processes, including human resources management systems.
- 1.29 The program strategy consists of supporting the Government of Honduras in the introduction of reforms (parametric) in its social security institutions and human resources management systems for the short and medium term. Through this support, the program will also help reduce the vulnerabilities of fiscal accounts and, consequently, contribute to recovery of the country's macroeconomic stability. Both aspects are consistent with the long-term vision referred to above.

²⁵ Primary education in Honduras is ranked 123 out of 139 countries according to the World Economic Forum competitiveness report 2010-2011. See http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf. Although primary education coverage is high in Honduras (97%), the percentage of trained teachers was only 36% in 2008, the second lowest level in the world. Source: World Bank.

- 1.30 With this strategy, the program specifically aims to help contain the fiscal impacts of the actuarial and liquidity problems of INPREMA²⁶ in the short term, and of INJUPEMP in the medium term. At the same time, the program is geared toward protecting the financial position and improving operations management in the IHSS, as well as strengthening control over spending derived from the large central government payroll, particularly the teacher payroll.
- 1.31 Considering the complexity and scope of the reforms mentioned, as well as the risks inherent in their approval by the legislative branch, while at the same time allowing flexibility in the sequence of fulfillment of the planned conditions, adoption of the programmatic loan modality is proposed, comprised of two single-tranche operations (see paragraph 2.1). The first programmatic loan is structured in three common components, namely: (i) macroeconomic stability; (ii) pension institution reform; and (iii) improvement of management of the central government's human resources, which are described for the first operation in the following section. The key results are described in Section I.C. below.

B. Objectives, components, and costs

- 1.32 The general objective of the program is to help the country's macroeconomic and fiscal stability take root through reforms that promote the long-term sustainability of pension institutions and control over unplanned growth of government employee salaries. The specific objectives are to support efforts by the Government of Honduras to reform its pension institutions and to introduce improvements in systems for administrative and budgetary control over the central government's human resources so as to lay the groundwork for building a more equitable and sustainable pension system and for improving human resources management in the central government.
- 1.33 **Component I. Macroeconomic stability.** This component establishes the condition precedent to disbursement of sustained macroeconomic and fiscal stability, in accordance with the program objectives and the guidelines established in the country's policy letter (see electronic link).
- 1.34 **Component II. Pension institution reform.** The objective of this component is to support the Government of Honduras in its efforts to strengthen the actuarial financial position of INPREMA, INJUPEMP, and IHSS.
- 1.35 **Subcomponent 1. Reform of INPREMA and INJUPEMP.** The objective of this subcomponent is to improve the actuarial sustainability of INPREMA and INJUPEMP. This is to be achieved through a parametric reform that bases benefits on the actual availability of contributions and expected returns on accumulated equity reserves. The reforms will include: (i) changes in the parametric variables and other factors that affect the calculation of benefits paid by the system, restoring the balance between income earned and benefits paid; (ii) fine-tuning of corporate

²⁶ See paragraphs 1.12 to 1.14.

- governance policies and standards, as well as professionalization of directors, officials, and employees of the institutions, with the purpose of establishing controls to eliminate poor practices leading to high administrative costs and incorrect operational and financial decisions; and (iii) granting of regulatory and supervisory authority to CNBS in its sphere of competence. For the specific case of INPREMA, the reform would also include a rule to align the number of new retirees with the institution's financial capacity (with the purpose of maintaining constant net equity).
- 1.36 With respect to INPREMA, the policy measure established as a condition for disbursement of the resources from the single tranche of the first programmatic loan is approval of changes to INPREMA's legal framework, including at least the following: (i) increase in the voluntary retirement age for new contributors, with a transition mechanism for preexisting participants; (ii) increase in the number of years of service for new contributors, with a transition mechanism for preexisting participants; (iii) increase in the number of months used to calculate the base salary for new contributors to determine the retirement benefit, with a transition mechanism for preexisting participants; (iv) inclusion of the thirteenth and fourteenth month salaries in the contribution base; (v) inclusion of a rule to align the number of new annual retirements with INPREMA's financial capacity; and (vi) granting of authority to CNBS to regulate and supervise INPREMA in its sphere of competence.
- 1.37 For INJUPEMP, the policy measure established as a condition for disbursement of the single tranche of the first programmatic loan is presentation to Congress of draft legislation to reform the institution's legal framework in order to improve its actuarial sustainability, including at least the following: (i) increase in the voluntary retirement age for new contributors, with a transition mechanism for preexisting participants; (ii) increase in the number of years of service for new contributors, with a transition mechanism for preexisting participants; (iii) increase in the number of months used to calculate the base salary to determine the retirement benefit, with a transition mechanism for preexisting participants; (iv) inclusion of the thirteenth and fourteenth month salaries in the contribution base; and (v) granting of authority to CNBS to regulate and supervise INJUPEMP in its sphere of competence.
- 1.38 The draft legislation for INPREMA and INJUPEMP that includes those measures was presented to the National Congress and is currently under discussion. In the case of INPREMA, the borrower anticipates that the draft legislation will be approved by Congress while the loan is being approved by the Bank's Board of Executive Directors, such that the conditions for disbursement of the proceeds of the first programmatic loan will be fully fulfilled in fiscal year 2011.
- 1.39 The planned trigger mechanisms for the second programmatic loan will be: (i) approval of a reform of INJUPEMP's legal framework geared toward improving its actuarial sustainability, including the minimum criteria listed in paragraph 1.37; (ii) issuance of the regulatory standards necessary for the competent entity to regulate and supervise INPREMA and INJUPEMP; and (iii) adoption of the

regulatory standards necessary to establish a new policy for investment of the reserves of INPREMA and INJUPEMP.

- 1.40 **Subcomponent 2. Reform of the IHSS.** The objective of this subcomponent is to stabilize the short-term financial conditions of the IHSS. Specifically, the subcomponent is aimed at increasing the revenues of the IHSS so as to protect the financial position of the pension system and to make it feasible to adopt measures aimed at improving operations management of the IHSS, particularly of the health system. This component will support adoption of an adjustment to the salary ceiling for contributions, with a fixed base. For such purposes, a tripartite agreement will be necessary between the private sector, workers, and physicians.²⁷ In order to facilitate achievement of this objective, the policy measure established as a condition for disbursement of the proceeds from the single tranche is approval by the IHSS of an internal regulation to raise the salary ceiling for contributions (by 46%), with a fixed base.²⁸
- 1.41 For the second programmatic loan, the proposed trigger mechanism is formulation of a plan for comprehensive reform of the IHSS to achieve the financial and actuarial viability of the systems and improvements in the institution's administrative and operations management, including at least: (i) separation of the pension and health systems; (ii) the evaluation and proposal of reforms of the models for health service delivery and the pension system; and (iii) corporate governance reform. The horizon for the reform proposals will be the long-term vision defined by the government as part of its objective to build a social security system that guarantees better living conditions for workers. A technical assistance operation has been approved (HO-T1159) to accompany this first programmatic loan to support development of these proposals.
- 1.42 **Component III. Improvement in management of the central government's human resources.** The objective of this component is to improve the capacity for monitoring and managing spending on the central government's human resources. This component will support the Government of Honduras in implementing and strengthening improved systems for administrative and budgetary control over the central government's human resources. With this objective, the policy measures that must be adopted as a condition for disbursement of the proceeds of the single tranche of the first programmatic loan, with an emphasis on teaching staff, include: (i) creation of an administrative agency specializing in the analysis, control, and monitoring of the payroll of public servants of the central government; (ii) development and implementation of a Teacher Management System incorporated into the Integrated Financial Management System (SIAFI); and

²⁷ The members of the Board of Directors of the IHSS and the representatives of the Executive Branch.

²⁸ In order to achieve this objective, the Board of Directors of the IHSS issued an internal resolution to raise the ceiling for contributions. That resolution was approved by the Board of Directors of the IHSS on 10 May 2011 through an amendment to SOJD Resolution 02-29-03-2011.

(iii) establishment of a mechanism for adjusting pay increases for teachers such that they are not indexed to the minimum wage.²⁹

- 1.43 The following are proposed as trigger mechanisms for the second programmatic loan: (i) design of a new teacher human resources system; (ii) design of a human resources management system integrated with the SIAFI for the central government, not including deconcentrated entities; and (iii) design of a mechanism allowing the professionalization of up to two key central government institutions.

C. Key results indicators

- 1.44 When the first programmatic loan ends, it is anticipated that it will have contributed to the long-term stability of the pension systems. In addition, various policy measures will have been adopted with the purpose of: (i) strengthening macroeconomic stability; (ii) improving the sustainability of public social security institutions; (iii) increasing the financial viability of the IHSS; and (iv) improving administrative and budgetary control over the human resources of the central government.
- 1.45 In the specific case of INPREMA, it is anticipated that approval of the draft legislation will result in a reduction in the actuarial deficit of 27.2% of GDP in 2010 to a range between 9% and 13%. With respect to the IHSS, an increase in revenues from contributions is expected of between 1% and 1.2% of GDP.
- 1.46 Regarding improvement in human resources management, the following indicators are expected by the conclusion of the first programmatic loan: (i) increase to 75% (from 26.75% in 2010) in the percentage of central government personnel incorporated into SIAFI; (ii) savings from purging of the payroll in the amount of 85 million lempiras (US\$4.5 million), equivalent to 0.6% of the annual teacher payroll.

²⁹ Indexing of teacher compensation is mandated in several articles of the Teachers' Statute. Article 46 states that "The value of the class hour for calculating the base monthly salary shall not be less than 0.71132 lempiras of the current average minimum wage... (which) is calculated by adding the lower and higher minimum wage established in the minimum wage law divided by two." Article 49 states that "The base salary and the value of the class hour for teachers will be automatically and directly increased based on the adjustments made to the minimum wage regulated by the corresponding law"; Article 50 states that "For certified teachers...compensation will be calculated based on academic degree, assigning them 69% over the current base salary"; lastly, Article 51 states that "Personnel regulated by this statute shall receive additional salary allotments for the following: position held; years of service; academic degrees earned; professional merits; and geographical area of the post. The increase in those allotments will be calculated on the base salary..." According to SEFIN estimates, applying the aforementioned articles to the minimum wages established in 2011 in Resolution STSS-223-2011 would mean a teacher payroll of approximately 59.9 billion lempiras in 2012, i.e., 290% higher than the payroll of 15.327 billion in 2011. This figure would increase the expenditure for compensation paid to employees of the central government to around 120% of the Honduran government's tax receipts.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

- 2.1 The program will be financed with two single-tranche programmatic loans: one for US\$40 million (US\$28 million with resources from the Ordinary Capital and US\$12 million with resources from the Fund for Special Operations), which is expected to be approved in late 2011, and another loan for an undefined amount that is expected to be approved in September 2012. The disbursement period for the first loan will be 12 months. The proposed operation will finance 3.4% of the consolidated public sector's financing needs for 2011, which are estimated to be US\$1.198 billion. The programmatic structure was selected instead of the multiple-tranche modality in order to give flexibility to the strategy for execution of the medium-term reforms. This modality leaves room for the second programmatic loan to respond to the new knowledge generated during execution of the first loan, including the results of the consulting services for preparation of a plan for comprehensive reform of the IHSS, which will be carried out with the support of a technical cooperation operation (HO-T1159).

B. Environmental and social safeguards

- 2.2 As a policy-based sector loan, this operation does not require classification of environmental or social impacts or safeguards.

C. Fiduciary risk

- 2.3 The proposed operation does not involve fiduciary risk. Disbursement of this policy-based programmatic loan will be in a single tranche once the policy conditions are fulfilled, such that the required financial control and management capabilities are minimal. In addition, the Ministry of Finance (SEFIN), which is the program executing unit, has executed several Bank-financed projects based on national financial management systems agreed with the government. Likewise, the project does not require procurement, which means that this risk is eliminated and no counterpart financing is needed.

D. Other issues and main risks

- 2.4 The broad framework of reforms that the government is promoting in the education sector³⁰ opens a window of opportunity to introduce reforms in INPREMA, providing it with long-term sustainability. While these reforms may face opposition from some unions, since early 2011, government authorities under the institutional and technical leadership of SEFIN and CNBS, and the political coordination of the President's Office, have carried out a broad public information campaign, including discussion and negotiation of the reforms with the leaders and representatives from

³⁰ The reforms include: a new General Education Law; establishment of an adjustment mechanism for teacher salary increases, not indexed to the minimum wage; and the reform of INPREMA. It should be noted that the Education Law, which is in the approval process, does not address the human resource management considerations included in this program's component III.

- all teachers associations, including representatives of INPREMA. So far the result has been positive, having reached basic consensuses with the interested parties, which has made it possible to present draft legislation to Congress for the reform of these institutions. At the request of the Government of Honduras, the Bank has supported the technical processes for discussion of the reform legislation.
- 2.5 A second risk is associated with the possibility that approval of the laws could affect the rights acquired by the institution's participants. However, if the reform does not take place, the institution's financial imbalance would have an adverse impact on the participants, putting present and future retirement payments at risk. Given the complexity of these risks and the scope of the proposed reforms, the Bank hired an international expert to evaluate the legal soundness of the draft legislation to reform INPREMA and INJUPEMP. The report from the consultant indicates that the reform proposals are not ambiguous with respect to the vested rights of participants who have fulfilled the requirements for retirement—even when those rights have not been requested—and also protect the equity capital of the active and passive participants who could be affected by the potential financial collapse of the institutions. Thus, this risk has also been offset, if we consider that in both cases the draft legislation has been designed to create more equitable and sustainable systems in line with the financial capacity derived from the reforms.
- 2.6 At the request of the teachers' unions, the review of both pieces of draft legislation had the support of the ILO. In this context, the changes proposed under both laws are based on the doctrinal principles of social security contained in international labor standards, specifically complying with the ILO Social Security (Minimum Standards) Convention (102).
- 2.7 With respect to potential implementation risks related to the reform, the draft legislation explicitly incorporates elements allowing greater control over the corporate governance of INPREMA and specific regulations concerning the oversight process. Specifically, the draft legislation provides for improvement of corporate governance policies and standards, as well as professionalization of the institution's directors, officials, and employees in order to establish controls that eliminate potential poor practices leading to high administrative costs and incorrect operational and financial decisions. In addition, the draft legislation grants powers to CNBS to review, verify, monitor, oversee, and supervise INPREMA with the purpose of preventing noncompliance with the resolutions of government regulators and supervisors due to the lack of legal sanctions.
- 2.8 Given the importance of the reforms of INPREMA and INJUPEMP, the World Bank and the Inter-American Development Bank have executed a coordinated technical assistance program to support evaluation and cultivate public support for the reform. As a result, and in tandem with this operation, the World Bank is approving a loan for budget support that includes social security institutions as one of its areas of reform.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 The borrower will be the Republic of Honduras. The executing agency will be SEFIN, which shall not preclude support from the policy actions of other institutions, such as the President's Office and CNBS, which are necessary for the integrity of the proposed reforms. SEFIN will have the following responsibilities: (i) delivering reports and evidence of adoption of the policy measures that are a condition for disbursement of the loan proceeds, as well as any other reports required by the Bank; (ii) promoting actions aimed at achieving the policy objectives defined in the program; and (iii) gathering, filing, and delivering to the Bank all information, indicators, and parameters that help the Republic of Honduras and the Bank monitor and evaluate the program outcomes.

B. Summary of arrangements for monitoring results

- 3.2 The borrower and the Bank have agreed to oversee the program through monitoring meetings to verify the status of the Results Matrix. The dates of those meetings will be determined by mutual agreement. For further details, see the optional link.

C. Significant design activities post approval

- 3.3 In order to facilitate achievement of the programmatic loan targets, technical cooperation funds will be provided. Operation HO-T1159 will finance a comprehensive plan of reforms for the IHSS, which will lay the groundwork for preparing a proposal to streamline the structure for governance and administrative, financial, and actuarial management of the institution.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	Aligned		
Lending Program	The intervention contributes to the lending program to small and vulnerable countries.		
Regional Development Goals			
Bank Output Contribution (as defined in Results Framework of IDB-9)	The intervention contributes to Bank output: Public financial systems implemented or upgraded (budget, treasury, accounting, debt, and revenues).		
2. Country Strategy Development Objectives	Aligned		
Country Strategy Results Matrix	GN-2475	The proposed operation contributes to the following 2010–2014 CS objectives: Fiscal efficiency and sustainability with enfasis on public spending.	
Country Program Results Matrix	GN-2617	The project is included in the 2011 Country Program Document.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	Highly Evaluable	Weight	Maximum Score
	8.6		10
3. Evidence-based Assessment & Solution	6.9	25%	10
4. Ex ante Economic Analysis	10.0	25%	10
5. Monitoring and Evaluation	7.5	25%	10
6. Risks & Mitigation Monitoring Matrix	10.0	25%	10
Overall risks rate = magnitude of risks*likelihood	Low		
Environmental & social risk classification	B.13		
III. IDB's Role - Additionality			
The project relies on the use of country systems (VPC/PDP criteria)	Yes	Financial Management: budget, treasury, accounting and reporting.	
The project uses another country system different from the ones above for implementing the program			
The IDB's involvement promotes 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.			

This operation seeks to contribute to fiscal and macroeconomic stability through support to reforms of the Honduran pension institutes, specifically by introducing improvements in the administrative and budgeting controls of human resources of the Central Administration and improvements in human resource management of the central administration. The program is structured on three components (i) macroeconomic stability (ii) reform of pension institutes and (iii) improvements in human resource management of the Central Administration.

Indicators in the results matrix have a baseline and well defined targets for the first year (2012). In most cases the targets are realistic. The project presents a cost-benefit analysis and for purposes of evaluation, the project proposes an ex-post cost-benefit analysis. The project has a risk matrix that identifies potential risks and mitigation measures.

POLICY MATRIX

Purpose of the programmatic policy-based loan: Support Program for Reform of Pension Institutions and the Human Resources Management System		
Objectives	Policy conditions for the first programmatic loan	Trigger mechanisms for the second programmatic loan
I. Macroeconomic stability		
Macroeconomic and fiscal stability	1.1 Maintenance of an appropriate policy framework that is consistent with the program objectives and with the guidelines established in the country's sector policy letter.	
II. Pension institution reform		
Subcomponent 1. Improve the actuarial sustainability of the National Pension Institute for Teachers (INPREMA) and the National Institute of Retirement and Pensions for Public Officials and Government Employees (INJUPEMP).	2.1 Approval of a reform of INPREMA's legal framework that includes at least the following: <ul style="list-style-type: none"> i. Increase in the voluntary retirement age for new contributors, with a transition mechanism for preexisting participants; ii. Increase in the number of years of service for new contributors, with a transition mechanism for preexisting participants; iii. Increase in the number of months used to calculate the base salary for new contributors to determine the retirement benefit, with a transition mechanism for preexisting participants; iv. Inclusion of the thirteenth and fourteenth month salaries in the contribution base; v. Inclusion of a rule to align the number of new annual retirements with INPREMA's financial capacity; and vi. Granting of authority to the National Commission of Banks and Insurers (CNBS) to regulate and supervise INPREMA in CNBS' sphere of competence. 	2.1 Approval of a reform of INJUPEMP's legal framework aimed at improving its actuarial sustainability that includes at least the following: <ul style="list-style-type: none"> i. Increase in the voluntary retirement age for new contributors, with a transition mechanism for preexisting participants; ii. Increase in the number of years of service for new contributors, with a transition mechanism for preexisting participants; iii. Increase in the number of months used to calculate the base salary to determine the retirement benefit, with a transition mechanism for preexisting participants; iv. Inclusion of the thirteenth and fourteenth month salaries in the contribution base; and v. Granting of authority to CNBS to regulate and supervise INJUPEMP in CNBS' sphere of competence.

	<p>2.2 Presentation to Congress of draft legislation to reform the legal framework of INJUPEMP so as to improve its actuarial sustainability, including at least the following:</p> <ul style="list-style-type: none"> i. Increase in the voluntary retirement age for new contributors, with a transition mechanism for preexisting participants; ii. Increase in the number of years of service for new contributors, with a transition mechanism for preexisting participants; iii. Increase in the number of months used to calculate the base salary to determine the retirement benefit, with a transition mechanism for preexisting participants; iv. Inclusion of the thirteenth and fourteenth month salaries in the contribution base; and v. Granting of authority to CNBS to regulate and supervise INJUPEMP in CNBS' sphere of competence. 	<p>2.2 Issuance of the regulatory standards necessary for CNBS to fulfill its role of regulation and supervision of INPREMA and INJUPEMP; and</p> <p>2.3 Adoption of the regulatory standards necessary to establish a new policy for investment of the reserves of INPREMA and INJUPEMP.</p>
Subcomponent 2. Stabilize the short-term financial conditions of the Honduran Social Security Institute (IHSS).	2.1 Approval by the IHSS of an internal regulation to raise the salary ceiling for contributions, with a fixed base.	2.1 Formulation of a plan for comprehensive reform of the IHSS to achieve the financial and actuarial viability of the health and pension systems and improvements in the institution's administrative and operations management, including at least: (i) separation of the pension and health systems; (ii) the evaluation and proposal of reforms for the health service delivery and pension system models; and (iii) corporate governance reform.
III. Improvement in human resources management		
Improve capacity for monitoring and managing spending on the central government's human resources.	3.1 Creation of an administrative agency specializing in the analysis, control, and monitoring of the payroll of public servants of the central government.	3.1 Design of a new teacher human resources system.
	3.2 Development and implementation of a Teacher Management System incorporated into the Integrated Financial Management System (SIAFI).	3.2 Design of a human resources management system that is incorporated into the SIAFI for the central government, not including deconcentrated entities.
	3.3 Establishment of a mechanism for adjusting pay increases for teachers such that they are not indexed to the minimum wage.	3.3 Design of a mechanism allowing the professionalization of up to two key central government institutions.