Honduras Public Expenditure Review

Strengthening Fiscal Resilience

WORLD BANK GROUP
Honduras Public Expenditure Review
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Abbreviations and Acronyms

BANADESA  Public Agricultural Development Bank
BANHPROVI  Development Bank
BCH  Central Bank of Honduras
CGR  General Accounting Office of the Republic
CL  contingent liability
COALIANZA  Commission for the Promotion of Public-Private Partnerships
DeMPA  Debt Management Performance Assessment
DGCP  General Directorate for Public Credit
DGID  General Directorate for Decentralized Institutions
DGIP  General Directorate of Investment
DGP  General Directorate of Budget
DGPMF  General Directorate for Macro-Fiscal Policies
DGSC  General Directorate of Civil Service
DMFAS  debt management and financial analysis system
DSA  debt sustainability analysis
ENEE  National Electric Power Company
ENP  National Ports Company
FRA  fiscal risk assessment
FRL  fiscal responsibility law
FRS  fiscal risk statement
FRU  fiscal risk unit
MMFMP  Medium-Term Macro-Fiscal Framework
ML  Municipalities Law
MT  medium term
MTDS  medium-term debt management strategy
NFPS  nonfinancial public sector
OBL  Organic Budget Law
PPP  public-private partnership
### Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>SAPP</td>
<td>PPP Superintendence</td>
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<tr>
<td>SAMI</td>
<td>Integrated Municipal Administration System</td>
</tr>
<tr>
<td>SEFIN</td>
<td>Secretaria de Finanzas (Ministry of Finance)</td>
</tr>
<tr>
<td>SIAFI</td>
<td>Integrated Financial Management System</td>
</tr>
<tr>
<td>SNP</td>
<td>National Public Investment System</td>
</tr>
<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
</tr>
<tr>
<td>TL</td>
<td>Transparency Law</td>
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<tr>
<td>UTEP-APP</td>
<td>Specialized Technical Unit for PPP Projects</td>
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All dollar amounts are in US dollars unless otherwise indicated. The analysis presented is based on the data available as of March 2022.
Executive Summary

Honduras remains one of the poorest and most unequal countries in the Western Hemisphere with a per capita annual income of US$2,831 (2021). Its economy is small, open, largely agricultural, and predominantly informal, with 10.1 million inhabitants. Real growth in gross domestic product (GDP) averaged 3.1 percent over the past decade (before the 2020 COVID-19 crisis), which was mainly driven by remittance-fueled private consumption. Almost half of the population lives on less than US$5.50 per day. 1 Structural exposure to external shocks and natural hazards go hand in hand with high levels of crime, political instability, and a weak institutional and business environment. These problems have undermined the country’s competitiveness and economic diversification, propelled emigration, and slowed progress toward raising incomes, reducing poverty, and tackling exclusion.

Vulnerability to external shocks, natural hazards, and fiscal risks constitute important development challenges. Historically, gains achieved during periods of relatively robust and broad-based growth were often wiped out by devastating shocks and followed by modest and uneven recoveries. The country is highly exposed to conditions in key external partners and to extreme climate events and disease outbreaks. Although external vulnerabilities have been contained in the run-up to the 2020 crisis amid prudent macroeconomic management anchored in the fiscal responsibility law (FRL), vulnerability to natural hazards and fiscal risks remains high. This situation compounds the growing exposure to contingent liabilities, especially from state-owned enterprises (SOEs), posing risks to macro-fiscal stability and constraining the country’s development. Large risks stem from the National Electric Power Company (ENEE), which concentrates the bulk of public guarantees and on-lending, and the public agricultural development bank (BANADESA).

The compound effect of the pandemic and two hurricanes in 2020 underscored the fragility of economic and poverty gains, and Honduras’s exposure to potential reversals. The impact of the COVID-19 crisis was exacerbated by two Category 4 hurricanes, Eta and Iota, in
November 2020, with severe damages to infrastructure, crops, and land. Both hurricanes affected about 4.7 million people (48 percent of the population), with social and economic costs estimated at US$1.8 billion (7.5 percent of 2020 GDP). The impacts of twin shocks further weakened the financial position of ENEE. The 2020 crisis has taken a particularly heavy toll on Honduras by regional standards amid low resilience and a more challenging political and governance environment. Real GDP contracted by a record 9 percent in 2020. Poverty (US$5.50 line) is estimated to have increased by 6.4 percentage points in 2020 to 55.4 percent as emergency programs had a relatively small mitigating effect on welfare.

**Substantial fiscal risks coupled with insufficient risk management and inefficient and rigid public spending constrain the country’s capacity to respond efficiently and effectively to shocks.** Persistent inefficiencies and rigidities in public spending, especially in the wage bill, have led to an overall acyclical fiscal policy that constrains the country’s capacity to respond to shocks. During crises, the government consistently relied on cuts to already relatively low public investment and to budget reallocations, which had negative repercussions on spending in other priority areas and reduced the ability to plan and track expenditures in the medium term. Similarly, in its response to the COVID-19 pandemic, the government allocated a small fiscal package compared with other LAC economies despite the country’s relatively low level of public debt and access to loans at below market rate. The high public wage bill and ENEE’s persistent deficit coupled with contingent liabilities constrain the required fiscal tightening post-2020, crowd out productive public investment, and undermine long-term growth and poverty reduction efforts. Furthermore, insufficient domestic private saving further limits domestic investment potential and weakens economic resistance to shocks. These rigidities, together with insufficient disaster and fiscal risk management, continued to inhibit the country’s resilience in the face of shocks.

**The crucial challenge faced by Honduran policy makers is to reinforce fiscal resilience to achieve, to protect, and to sustain income and poverty gains.** This goal could be achieved by implementing a forward-looking fiscal strategy that combines adaptation investment and dedicated budget resources to quickly scale up spending in case of a natural hazard without jeopardizing other development objectives. Dedicating budget resources to investment in disaster resilience and response to shocks ex-ante will enable Honduras to conduct a more countercyclical fiscal policy. Strengthening fiscal resilience will then require Honduras to implement policies that could help address fiscal constraints while safeguarding critical investment, basic services, and social assistance for its poorest citizens. Improving the quality and efficiency of public expenditures, especially in procurement, the wage bill, and targeted transfers will be essential to gaining necessary fiscal space. Preserving fiscal discipline and advancing on the implementation of structural reforms in the energy sector will be critical to safeguard fiscal sustainability. The successful implementation of these reforms rests on strengthening public investment management, implementation capacity, and institutional quality.

**This Public Expenditure Review (PER) considers key fiscal challenges faced by policy makers to strengthen fiscal resilience and sustainability: significant fiscal risks and the high public wage bill.** First, the PER analyzes expenditure and revenue trends and their implications
for fiscal sustainability and resilience in chapter 1. It provides an overview of macro-fiscal developments and policies since 2014, studies the impact of the COVID-19 pandemic and the hurricanes on macro-fiscal developments, and discusses the macroeconomic challenges in the recovery phase. Second, the PER discusses key fiscal risks and ways to strengthen fiscal resilience through fiscal risk management, proactive fiscal policy, and disaster risk management in chapter 2. It analyzes explicit and implicit contingent liabilities in the public sector, particularly in ENEE and BANADESA, as well as exposure, damages and contingent liabilities caused by climate-induced natural hazards. Third, the PER raises the issue of efficiency and performance of public spending in relation to the central government’s wage-setting framework. Chapter 3 analyzes the drivers of the high wage bill and examines the legal and institutional framework governing the public sector wage bill, which requires a thorough revision of the compensation structure to improve transparency, fairness, and incentives in the public sector, thus leading to improved public sector performance. These topics have been of special interest to policy makers in Honduras.

**Fiscal Risks: Sources and Management**

Honduras’s public finances are exposed to a variety of fiscal risks that were exacerbated by the COVID-19 pandemic and Hurricanes Eta and Iota in 2020. The main source of contingent liabilities is the subset of debt-related liabilities stemming from the public sector, such as risks from the borrowing of subnational governments, state-owned enterprises (SOEs), litigations, and public-private partnerships (PPPs). Other significant risks arise from the management of trust assets and liabilities and natural hazards. The largest contingent liabilities stem from the troubled state electricity company ENEE, further exacerbated by liquidity pressures brought by the pandemic and the hurricanes. Overall, explicit and implicit contingent liabilities from SOEs, litigations, and PPPs roughly range between 35 percent and 70 percent of GDP, depending on the severity of the assumptions.

**High vulnerability to natural hazards exposes Honduras to significant contingent liabilities.** On the basis of historical growth and natural hazard risk patterns, the combined impact of destroyed productive capital by excess rain, strong winds, and earthquakes would amount to cumulative losses of about 5.4 percent of GDP by 2050. Lower growth, forgone revenue, and resources needed for reconstruction and relief efforts also weigh on the private sector’s profitability and the government’s fiscal stance, increasing public debt levels by about 6.2 percentage points of GDP by 2050. With an annual probability of 1.0 percent, contingent liabilities from these three natural hazards would amount to at least 8.5 percent of GDP but rises to at least 16.1 percent in the worst 0.2 percent (1-in-500 years) of outcomes. Natural disasters are recurrent, and their frequency and intensity are likely to increase in the context of climate change, hence exacerbating their impacts in the absence of adaptation policies.

**Natural hazards can trigger instability in the banking sector given its high exposure to physical risks from hurricanes and limited resilience amid physical and transitional risks, raising the need for fiscal support.** Using the information on Hurricanes Eta’s and Iota’s impacts on borrowers’ creditworthiness as a benchmark, 6.2 percent of all loans could become nonperforming, triggering a 3.3 percentage point drop in banks’ tier 1 capital ratio by 2050. Climate change...
could also increase the expected annual damage from river floods in Honduras by 13.0 percent by 2050. Nevertheless, the risk to the banking sector from these stronger floods remains moderate. Moreover, although longer and more frequent droughts are expected to affect agriculture production, the impacts to the banking sector’s credit quality are expected to be limited. However, severe data limitations did not allow the assessment of the impacts and contingent liabilities of these and other natural hazards in key sectors, including agriculture.

**Honduras incorporated disaster risk management—the key element of climate change adaptation and fiscal resilience—and took steps to increase the banking sector’s resilience.** In December 2020, the authorities published the Strategy for Disaster Risk Finance Management, which proposed a framework for setting a financing strategy to respond to postdisaster financing needs. The implementation of the strategy would help promote climate resilience and emergency response and provide a fiscal buffer to mitigate the risk to fiscal stability in the event of future hazards. The authorities also took several steps to increase the banking sector’s resilience. In December 2020, the Comisión Nacional de Bancos y Seguros required local banks to set a restricted nondistributable capital reserve. Authorities set regulatory forbearance measures, which allowed borrowers affected by COVID-19 and later by Hurricanes Eta and Iota to restructure and refinance their loans.

**Honduras has also made substantial progress over the past years in managing fiscal risks.** The government created a fiscal risk unit (FRU) in 2015 within the Ministry of Finance (SEFIN), tasked with identifying, quantifying, and reporting fiscal risks using a fiscal risk management framework. Relevant risk analysis has been published in a fiscal risk statement (FRS), which is well-developed and comprehensive and complies with the legislation except for risks from natural hazards. The scope of risks covered and the analysis itself have been increased substantially in the 2021 FRS, compared with the previous version, as it also includes suggestions for risk mitigation measures. Furthermore, the legal and institutional framework also includes provisions for specific risks, such as loan guarantees.

**Nevertheless, fiscal risk management is insufficient to comprehensively address and mitigate the impacts of shocks, undermining fiscal and debt sustainability.** In practice, risk management remains limited to monitoring fiscal risks as opposed to managing the country’s exposure within a more comprehensive perspective. The FRU’s analysis of global risk is not taken into account in the medium-term macro-fiscal framework, the implementation of fiscal rules, or the selection of the borrowing limits. The FRS contains no critical information on the country’s exposure to and management of risks specific to PPPs, the debt portfolio of non-financial public sector entities, or the energy sector. The legal framework is not comprehensive, lacking risk mitigation measures, with most clauses focusing on risk monitoring, and is not fully implemented.

**Proactive and comprehensive fiscal risk management would require implementing additional risk mitigation measures and enhancing the governance and legal framework.** To effectively address fiscal risks, the authorities need to implement more proactive risk management
with the application of risk mitigation tools, more effective presentation of risks, and better integration of SEFIN reporting. Authorities also need to enhance the governance framework for loan guarantees and on-lending through clear policy objectives; analysis of alternative financing options; and implementation of risk mitigation tools, including budget appropriations. Most important, these reforms should aim at addressing the structural weaknesses of ENEE. Disaster risk management should aim to mitigate the financing gaps in a cost-efficient way and output and welfare losses in the event of natural hazard-related shocks.

Further, a more proactive and forward-looking fiscal policy is a key step to strengthen resilience in the face of natural hazards. Such a strategy could combine adaptation investment and dedicated budget resources to quickly scale up spending on reconstruction and cash transfers to households in case of a disaster without jeopardizing other development objectives. A financing strategy that uses disaster risk insurance could provide quick additional liquidity in the event of a disaster; additional borrowing in the short term could finance adaptation policies; and medium-term additional revenue generation could help finance needs across the board. A proactive fiscal policy strategy could also involve planning ex ante a set of financial instruments with a predefined order of precedence in the event of a natural disaster. Fiscal buffers and reforms that reduce the exposure of public budgets to climate shocks should be explored, as well as regulations and incentives for private sector investments in resilience. Strengthening the climate-related supervisory and regulatory toolkit is important to enhance the financial sector’s resilience amid physical risks.

Public Sector Wage Bill

Honduras’s public wage bill is the main category of spending in the country’s public expenditure profile, and high by international standards. Personnel-related expenditures amounted to 12.2 percent of GDP in 2020 and accounted for close to 36.0 percent of total outlays, the largest single expenditure item. Despite decreasing over the past several years relative to GDP, Honduras’s public sector wage bill has remained high when compared with structural and aspirational international peers, member countries of the Organisation for Economic Co-operation and Development, and most Central American and Latin America and the Caribbean countries.

Employment in the public sector as a share of formal employment is below international benchmarks, suggesting that the large wage bill is mainly the result of the high level of public sector salaries. When compared with the private sector, public sector wages in Honduras are the second highest in Latin America and the Caribbean, potentially crowding out talent from the private sector.

High wage bill hinders the reallocation of resources to improve service delivery and limits the space for discretionary fiscal policy in the event of an emergency. With 70 percent of resources devoted to salaries, mainly at the central administration level—almost 40 percent of which are in the education sector—an effective management of the wage bill is critical to strengthen efficiency of public spending. In 2020, the government designed and approved a central mechanism for salary negotiations to guide decisions on nominal wage increases, in line
with the FRL, that should help contain the wage bill and support spending limits. Containing the growth of the wage bill will help reduce budget rigidities and enable reallocation of resources to critical investments that promote growth and improve service delivery to citizens. With measures that reduce waste of public resources through improved efficiency, the reform will support the required fiscal tightening and bring public sector wages closer to those in the private sector.

Yet, the structural features of Honduras's public employment and remuneration framework undermine government efficiency. Parallel regimes for employees and institutions in multiple entities and organizations at different levels of the state preclude a unified management of wages and give rise to discretionary salary adjustment mechanisms. The legal framework is outdated and institutional arrangements are weak, with virtually no high-level public administration authority responsible for human resources policies. Together with additional challenges from limited skills, poor information systems, and scant resources, this shortcoming hinders consistent improvements in managing the public wage bill.

Achieving the necessary efficiency in managing the wage bill requires a comprehensive reform of the human resources management system. Such an effort must tackle the legal, institutional, and fiscal spheres to guarantee the desired effects. This PER proposes sequenced measures to improve the ecosystem of public sector employment. Those measures would (a) have positive effects on the leadership of the civil service; (b) address the challenges of improving the profile and the technical skills of the employees in relation to the responsibilities assigned; (c) contribute to the rationalization, balance, and sustainability of the wage bill; and (d) create an environment more conducive to the development of a more professionalized and responsible public sector employment system.

Policy Recommendations

This PER identified three key policy levers (see table ES.1) to strengthen Honduras’s fiscal resilience. These policy levers consider two filters: the feasibility of the measures and the relative urgency to act, which promote a focus on specific recommendations that can inform policy in the short to medium term and open the door to engagement on broader reforms in the long run. Maintaining macroeconomic stability and fiscal discipline should remain center stage. Doing so will require continued implementation of prudent macroeconomic policies, adherence to the FRL, improvements in public expenditure efficiency, renewed revenue mobilization efforts, and transition to a more countercyclical fiscal policy, among other measures. Managing fiscal risks and increasing resistance to shocks will be important for ex ante recovery and reconstruction. It will require improving fiscal risk management, enhancing the governance framework for loan guarantees and on-lending, taking steps toward resolving the issues in the energy sector, and strengthening prevention and disaster risk management. With limited fiscal resources, balancing disaster risk management, reconstruction, and adaptation with other development needs is a critical fiscal policy objective through a more proactive fiscal policy. Further, managing the wage bill is warranted. Such management could be achieved through controlling the growth of the wage bill and improving the spending efficiency of public wages. Together with key structural reforms
to improve governance and institutional quality, these policies could enhance Honduras’s fiscal resilience in the face of shocks.

The design of the fiscal strategy should be based on the careful prioritization across all development objectives, capacity constraints, and sustainability (macroeconomic, fiscal, social, and environmental) considerations. The prioritization of these policies and further detailing of policy actions are subject to further analyses to make more informed decisions about the available instruments. Moreover, to enable a detailed analysis, strengthening fiscal transparency by collecting, recording, monitoring, and publishing more granular data on revenues and expenditures, fiscal risks, and contingent liabilities in the public sector, and public sector employment under all regimes, are essential.

Table ES.1: Recommendations for Strengthening Fiscal Resilience

<table>
<thead>
<tr>
<th>Policy Lever</th>
<th>Recommendation</th>
<th>Timing</th>
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<tbody>
<tr>
<td>Managing macro-fiscal policy</td>
<td>▪ Resume the compliance with the FRL by gradually unwinding pandemic and posthurricane support, budget reallocations, revenue growth aided by the economic recovery, revenue mobilization measures, and strict spending controls.</td>
<td>Short to medium term</td>
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<td>▪ Strengthen tax policy and tax administration, including revenue management by (a) gradually reducing tax expenditures and broadening the tax base and (b) strengthening tax administration and enforcement mechanisms to minimize tax evasion.</td>
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<td></td>
<td>▪ Transition toward a more countercyclical fiscal policy by dedicating budget resources to investment in disaster resilience and response to shocks ex ante.</td>
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<td>▪ Improve the quality and efficiency of public expenditures, especially in procurement, the wage bill, and targeted transfers by rationalizing current spending and ensuring that resources spent yield the highest social rate of return, whether in growth or equity promotion.</td>
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<td>▪ Further prioritize capital spending, which would have a positive effect on capital accumulation and economic growth and could attract private investments in key economic sectors.</td>
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<td>▪ Further incentivize domestic private and public saving and investment.</td>
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<td>Policy Lever</td>
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<td>Timing</td>
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<tr>
<td><strong>Managing fiscal risks</strong></td>
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<td>Strengthen fiscal risk management</td>
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<td>Implement more proactive fiscal risk management, including using risk mitigation tools and budget appropriations to inform fiscal policies.</td>
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<td>Strengthen the FRS by including the following:</td>
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<td>— A methodological note to describe the conceptual framework of selected risk models</td>
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<td></td>
<td>— A chapter dedicated to the energy sector and applying a tailored risk assessment methodology for ENEE</td>
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<td></td>
<td>— More details on the risk exposure and strategies to mitigate it by better linking and integrating different reports on fiscal risks</td>
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<td>Strengthen the FRS by including the following:</td>
<td>Short to medium term</td>
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<td>— More details on the risk exposure and strategies to mitigate it by better linking and integrating different reports on fiscal risks</td>
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<td>Improve coordination between the FRU and DGCP to enhance statistics and reporting.</td>
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<td>Adhere and expand the legal and institutional framework to include provisions for central government on-lending.</td>
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<td></td>
<td>Reinforce and implement the governance framework for loan guarantees and on-lending through the following:</td>
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<td>— Clear policy objectives</td>
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<td>— Analysis of alternative financing options</td>
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<td>Implement risk mitigation tools, including budget appropriations.</td>
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<td>Develop a plan to assist SOEs in completing external financial audits, for example, through an SOE, SEFIN, and a court of auditors working group.</td>
<td>Medium term</td>
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<td>A deep and broad governance, structural and institutional reforms are needed to manage and mitigate fiscal risks from ENEE. The key priorities include the following:</td>
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<td>— Preparing a credible loss-reduction program to reduce transmission and distribution losses, and take adequate measures for its early implementation</td>
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<td>— Improving governance and efficiency in power theft detection and mitigation</td>
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<td>— Implementing the tariff regulations based on an updated cost-of-service study to reach full cost recovery</td>
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<td>— Preparing network investment plans</td>
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<td>— Adopting a program with a deadline to eliminate arrears from public sector consumers</td>
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<td>Strengthen prevention and disaster risk management:</td>
<td>Medium term</td>
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<td></td>
<td>— Operationalize the Disaster Risk Finance Management strategy.</td>
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<td>— Transition to a more proactive and strategic fiscal policy that combines adaptation investment with fiscal provisions to quickly finance additional expenditure for reconstruction and relief to affected populations after a disaster.</td>
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<td>Enhance the financial sector’s resilience amid physical and transition risks by further strengthening the climate-related supervisory and regulatory toolkit.</td>
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<tr>
<td>Policy Lever</td>
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</table>
| Managing the wage bill            | **Control the growth of the wage bill**  
  - Reinforce the planning and management capacity of decision makers on the wage bill through the following:  
    - Analyzing and selecting the best policy scenarios in the most representative sectors in the wage bill that allow for efficiency gains and reduced waste, based on better quality data  
    - Publishing and implementing the central wage negotiation mechanism, complementing it with established multiannual global negotiation caps  | Short term   |
| Improve spending efficiency of public wages | **Follow a road map for a sequenced comprehensive civil service reform covering**, among others, the following key actions:  
  - Upgrading the DGSC to a public administration authority and strengthen its technical and operating capacity  
  - Harmonizing labor regimes and adjusting regulations that serve as building blocks for a new civil service law  
  - Improving data records and integration of human resources management information systems, to improve analysis and evidence-based decision making  
  - Setting up new tools and mechanisms for improved recruitment, selection, and career management  
  - Rationalizing salary scales on the basis of salary equivalences, and working toward a comprehensive salary policy  
  - Strengthening transparency mechanisms in human resources management  | Short to medium term |

**Notes**: Short term = 1–2 years; medium term = 3–5 years. The civil service reform road map includes some long-term actions beyond five years. DGCP = General Directorate for Public Credit; ENEE = National Electric Power Company; FRL = fiscal responsibility law; FRS = fiscal risk statement; FRU = fiscal risk unit; SEFIN = Ministry of Finance; SOE = state-owned enterprise.

**Notes**

1. This report measures poverty using the international poverty lines expressed in US$ 2011 PPP. A new set of international poverty lines, expressed in US$ 2017 PPP were introduced in August 2022. Thus, while the overall trends over time remain unchanged, the levels are different under the two lines.

2. As of the end of June 2022, Honduras reported more than 426,000 cases and 10,904 deaths—among the highest numbers (as a share of total population) in Central American countries. Honduras’s growth was also affected more than other countries in the Latin America and Caribbean (LAC) region and other developing countries in the world by the COVID-19 crisis in 2020.

3. Climate change is expected to increase global mean temperatures; to intensify weather events, such as floods, heat waves, and droughts; and to increase sea-level rise. Since Honduras’s disaster losses from natural hazards are mostly from climate-induced natural hazards, the increase in their frequency and severity is expected to exacerbate their impacts. See H.-O. Pörtner et al., eds., Climate Change 2022: Impacts, Adaptation, and Vulnerability, Contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change (Cambridge: Cambridge University Press, 2022).

4. At the time of this report’s preparation, the mechanism had not been implemented.
1. Macro-Fiscal Developments

Frequent shocks destabilized the Honduran economy, eroding income and poverty reduction gains previously achieved. Between 2014 and 2019, prudent macroeconomic and fiscal management reduced macroeconomic imbalances. However, growth remained modest and insufficient to reduce poverty, whereas fiscal policies did not sufficiently enhance the economy’s resilience against shocks. The COVID-19 pandemic and Hurricanes Eta and Iota followed the same unfortunate pattern, affecting Honduras more than other countries in the Latin America and the Caribbean region. Output contracted by a record 9 percent in 2020, pushing more than 700,000 people into poverty. The government’s targeted policies and expenditure reallocations helped cushion the effects of the twin shocks amid the activation of the escape clause of the fiscal responsibility law (FRL). Adherence to the FRL will be critical to safeguard fiscal sustainability. However, fiscal tightening is challenging given significant reconstruction and health needs, as well as budget rigidities. Fiscal risks, including those from state-owned enterprises and natural hazards, could derail the adjustment. Strengthening fiscal risk, increasing spending efficiency, and enhancing revenue collection would support the required tightening and enhance Honduras’s fiscal resilience against future shocks.
1.1 Macroeconomic context

Honduras remains one of the poorest and most unequal countries in the Western Hemisphere, with a per capita annual income of US$2,831 (2021). Honduras’s is a small, open, largely agricultural, and predominantly informal economy with 10.1 million inhabitants. Real growth in gross domestic product (GDP) averaged 3.1 percent over the past decade (before the 2020 COVID-19 crisis), mainly driven by remittance-fueled private consumption. Structural sensitivity to external shocks and natural hazards is combined with high levels of crime, political instability, a weak institutional and business environment, and the thin economic base for generating more and better jobs. These problems have undermined the country's competitiveness and economic diversification, propelled emigration, and slowed progress toward raising incomes, reducing poverty, and tackling exclusion.

Vulnerability to external shocks, natural hazards, and fiscal risks constitute Honduras’s important development challenges. The economy is highly exposed to conditions in key external partners as capital formation in Honduras depends mainly on private financing sources, such as foreign direct investment (FDI), and consumption is funded primarily by high remittance inflows.¹ The country’s high exposure to two main types of natural hazards—extreme climate events and disease outbreaks—threatens its economic stability and the safety and well-being of its population.² These shocks compound the growing exposure to contingent liabilities, especially from state-owned (SOEs), posing risk to macro-fiscal stability and constraining the country’s development. Historically, gains achieved during periods of relatively robust and broad-based growth were often wiped out by devastating shocks and followed by modest and uneven recoveries.

External vulnerabilities have been limited after 2014 because of contained fiscal deficits, a strong external position, and historically low inflation. Declining fiscal deficits and strengthened macroeconomic management since 2014 helped improve Honduras’s external position.³ The current account deficit narrowed to an average of approximately 4 percent of GDP during 2014–19 (from an average deficit of −8.7 percent of GDP during 2011–13), supported by strong FDI (figures 1.1 and 1.2). Annual remittances growth of 12 percent (almost double the 2010–15 average) and strong coffee exports contributed to a narrowing current account deficit. Inflation has decelerated since 2015 and has been stable at about the 4 percent ± 1 percent target band of the Central Bank of Honduras (BCH), despite inflationary pressures stemming from strong domestic demand, rising oil prices in 2018, and increased electricity tariffs. Monetary policy, anchored in the crawling-band exchange rate regime with ample foreign reserves (22.9 percent in 2019) and a sound financial sector supported macroeconomic stability in the run-up to the 2020 crisis. Going forward, leveraging remittances as macroeconomic stabilizers and transitioning toward a more flexible exchange rate regime will help the Honduran economy address external shocks more efficiently and strengthen economic resilience.⁴

However, vulnerability to natural hazards and fiscal risks remains high. Extreme weather has caused an annual average loss equivalent to 2.3 percent of GDP between 1980 and 2020, affecting critical sectors, such as transportation, telecommunications, water and sanitation, health, and education.⁵ Climate change is expected to intensify the frequency of extreme weather and
exacerbate its impacts. Such events are estimated to generate at least 8.5 percent of the 2020 GDP in contingent liabilities, with an annual probability of 1.0 percent. Any unaddressed effects from climate changes will have significant consequences for the entire Honduran society and key economic sectors, threatening food and water security, health, well-being, and the country’s growth prospects. Hurricanes and more intense and frequent droughts resulting from climate change will also have a negative effect in the already-stressed power sector. The total debt and contingencies of the troubled state electricity company has been growing rapidly over the past decade, reaching nearly 20 percent of GDP (2021) and presenting a key fiscal vulnerability in Honduras.

Substantial fiscal risks coupled with insufficient risk management and inefficient and rigid public spending constrain the country’s capacity to respond efficiently and effectively to external shocks. Persistent inefficiencies in public spending, especially in the wage bill, have led to an overall acyclic fiscal policy that constrained the country’s ability to respond to shocks. During crises, the government consistently relied on cuts to already relatively low public investment and to budget reallocations, which had negative repercussions on spending in other priority areas and reduced the ability to plan and track expenditure in the medium term. Moreover, insufficient domestic private saving limits domestic investment potential and further weakens economic resistance to shocks. These rigidities, together with insufficient disaster and fiscal risk management, continued to inhibit the country’s resilience against shocks and crowded out productive public investment. In turn, this undermined long-term growth and efforts to reduce poverty.
Those vulnerabilities contributed to modest growth rates that were insufficient to reduce poverty and inequality. The country’s real GDP growth averaged 3.7 percent over the 2014–19 period, lower than the growth rates of its structural (4.3 percent) and aspirational peers (6.2 percent, figure 1.3).\(^9\) Growth was broad based, with the biggest contribution coming from services (2.76 percent), manufacturing (0.81 percent), and agriculture (0.51 percent, figure 1.4). Factor accumulation was the main driver of growth as productivity declined (figure 1.5). Growth did not significantly improve livelihoods as reflected by the modest increase in per capita GDP from US$2,206 in 2014 to US$2,574 in 2019. Poverty reduction under the country’s official poverty line was relatively stagnant between 2014 and 2019. In 2019, 25.2 percent of the population lived in extreme poverty and almost half (48.0 percent or 4.4 million people) lived in poverty, based on the official poverty lines.\(^9\) Inequality continues to be among the highest in the Western Hemisphere, with a Gini coefficient of 49.9 in 2019, relatively stagnant for the past five years.

Private consumption accounted for 85 percent of growth on the demand side of the economy, whereas the contribution of investment remained subdued (figure 1.6). Private consumption remains the key driver of growth, owing to increasing labor force participation rather than increases in the productivity of labor. Increasing remittance inflows, which accounted for 21.4 percent of GDP in 2019 and about 30 percent of household income of the poorest remittance-receiving households, fueled consumption and therefore growth. The contribution of private investment, however, remained low at 0.6 percent on average, undermined by the country’s shallow capital markets and weak regulatory and business environment. Whereas the financial infrastructure in Honduras improved recently and domestic credit to the private sector rose from 55.0 percent of GDP in 2014 to 63.9 percent in 2019, thereby placing Honduras broadly in line with most regional peers, the access to credit and financial instruments for firms, banks, and investors remains limited.\(^11\)
The recent deceleration in investment inflows and trade, combined with limited cross-sector spillovers has negatively affected growth. Net FDI inflows averaged 5.7 percent of GDP during 2014–19, well above the LAC average of 3.7 percent. Trade flows averaged 103.9 percent of GDP over the same period, more than double the LAC average of 45.3 percent. However, both private investment and trade, including in the maquila sector, decelerated compared with 2010–15. Moreover, being concentrated in the maquila sector, which roughly accounts for 60 percent of total FDI in the country, trade and investment generated limited cross-sector spillovers. This eroded the potential growth effects of foreign investment, constrained the development of new opportunities, and further exacerbated the limited gains in productivity.

The COVID-19 pandemic and back-to-back Hurricanes Eta and Iota dealt severe blows to the Honduran economy. The crises of 2020 affected Honduras more than other countries in the region and other developing countries in the world amid a more challenging political and governance environment. Real GDP contracted by a record 9 percent in 2020. In addition, both hurricanes affected about 4.7 million people (48 percent of the population) with social and economic costs estimated at US$1.8 billion (7.5 percent of 2020 GDP) amid damages to key productive infrastructure, land, and crops. Output contracted across nearly all sectors, particularly in export-oriented sectors, owing to the pandemic (agriculture, textile) and in transportation, local infrastructure, agriculture, and housing owing to the hurricanes (see box 1.1).

Increased unemployment and decelerated remittance inflows reduced household income and domestic consumption. Strict lockdown measures reduced supply and demand in the economy and negatively affected firm profitability, employment, and incomes. By the end of 2020, 10.2 percent of firms had closed permanently and only 16.2 percent had been able to return to their prepandemic level of operations as of early 2021. About 400,000 people lost their jobs in 2020,
Box 1.1. Effects of COVID-19 and Hurricanes Eta and Iota on the Honduran Economy

- Global supply chains are being disrupted. This disruption reduced the availability of intermediate and capital goods owing to lockdown measures and transport disruptions. In 2020, output in the agriculture and industry (including the maquila) sectors contracted by 6.3 and 14.3 percent year over year, respectively. Honduras’s imports decreased by 18.5 percent, also reflecting reduced domestic purchasing power and demand because of the crisis.

- Export demand weakened (including for textiles, apparel, and coffee). Slower external demand, strict domestic lockdowns, crop losses, and infrastructure disruptions caused by the hurricanes, coupled with disrupted input supply, caused a 20.3 percent reduction in exports in 2020. Specifically, the downturn in the US consumer market has caused maquila’s leading brands and retailers to cancel or delay orders from Honduran suppliers. Maquila exports dropped by 41.0 percent in the first half of 2020, mainly reflecting a decline in apparel exports. Slowing economic activity has reduced the income of producers and smallholder farmers, eroding their purchasing power and threatening their solvency.

- Remittance and foreign investment inflows slowed. Although remittances increased in 2020 on an annual basis, from US$5.4 billion in 2019 to US$5.6 billion in 2020, the growth in remittance inflows slowed markedly. Weak external demand and political uncertainty amid the presidential elections in 2021 contributed to a slowdown in foreign direct investment inflows (concentrated mainly in the maquila sector).

- The external shock has been reinforced by an even stronger domestic demand and supply shock, weighing down the economy significantly and imposing significant financial stress on households and micro, small, and medium enterprises. The most affected sectors involve nonessential consumer goods and services, such as furniture production, light manufacturing, and tourism. Formal firms reported a major contraction in sales and revenues between 2019 and 2020, and the number of firms that filed value-added tax returns fell sharply. Small firms were among the most affected, especially in the service sector.

with the majority being in manufacturing and services. Poverty (US$5.50 line) is estimated to have increased by 6.4 percentage points in 2020 to 55.4 percent as emergency programs had a relatively small mitigating impact. Growth in remittances decelerated to 3.8 percent (year over year) in 2019, only partially compensating for the income loss. As a result, private consumption declined by 6.4 percent in 2020.

Honduras has implemented targeted policies to cushion the effect of the twin shocks on economic activity and livelihoods. In response to the crisis, the government implemented a containment and response plan, provided targeted support to micro, small, and medium enterprises, and adopted an economic rescue plan and a long-term plan for reconstruction and sustainable development. These actions aimed at rebuilding productive assets and infrastructure, strengthening the economy’s sustainability and resilience against natural hazards, and expanding
social protection programs. Honduras focused its short-term efforts on the emergency response in the health sector, while also assisting vulnerable households and affected firms by providing liquidity support, transfers, forbearances, and credit relief, as well as poststorms reconstruction. The country’s relatively low public debt and deficit levels, coupled with good access to concessional financing, allowed for the countercyclical response. Fiscal measures included the following:

- The FRL’s escape clause was activated in 2020, with subsequent upward revisions of the non-financial public sector (NFPS) deficit limits for 2020–22.
- New borrowing of US$2.5 billion (10 percent of GDP) for 2020–21 and an additional borrowing for up to US$2.0 billion for 2022–23 was authorized.
- Nonpriority spending to finance emergency expenditures was reallocated. Increased health care and social spending was estimated at about 1.8 percent of GDP and natural hazard spending was estimated at 0.2 percent of GDP in 2020.
- Revenue measures were introduced to support firms through tax relief, temporary exemptions, and forbearances, including advanced corporate income tax payments, one-off income tax credits for companies that maintained their employment levels from before the crisis, and temporary value-added tax (VAT) exemptions for medical supplies. Income taxes and social contribution payments were deferred to late-2020 and 2021, and VAT payments for small and medium enterprises (SMEs) that were closed during the lockdown were deferred.
- Transfers or forbearance to individuals included unemployment benefits to formal workers, cash transfers of L 2,000 per month (about US$81) to informal workers, and distribution of food supplies and other basic items to more than 1 million poor households.
- Withdrawal of US$335 million was approved from the International Monetary Fund’s (IMF) Special Drawing Rights in early 2022.

Monetary and financial policy measures provided additional stimulus and liquidity support. The support included the following measures:

- The BCH cut the policy rate by 250 base points from 5.5 percent in January 2020 to 3.0 percent in November 2020, suspended liquidity absorption operations, and reduced the spread for its emergency lending facility and repurchase operations over the policy rate.
- The BCH implemented two credit guarantee plans created to encourage the granting of credit during the pandemic and the postpandemic recovery, which have also contributed to maintaining stability in the financial system.
- The BCH temporarily reduced the legal reserve requirements for deposits on national currency for commercial banks from 12 to 9 percent while reintroducing temporary mandatory investments of 3 percent backed by new credits to micro and small enterprises supported by the guarantee scheme and credits from financial institutions.
- The development bank BANHPROVI provided roughly 1 percent of GDP in guarantees for lending to SMEs and other firms.
- Financial institutions temporarily suspended debt service of liquidity constraint companies and individuals whose incomes were affected by the pandemic and the hurricanes.
- Commercial banks provided a loan restructuring plan for SMEs.
After the historic contraction, Honduras’s real GDP reached its precrisis level in 2021. Real GDP grew 12.6 percent year over year in 2021, driven by remittance-fueled private consumption and investment associated with reconstruction activities and robust export demand. The rebound in economic activity was led by a strong pick up in manufacturing and services, whereas the recovery in the agriculture sector was subdued amid severe damages to crops and land. Growth in remittances (24.3 percent of GDP in 2021) accelerated by 19.6 percent year over year in 2021. Yet, as of mid-2021, about 41 percent of households reported incomes below the pre-pandemic level as about one in three workers in Honduras lost their pre-pandemic job. Poverty (US$5.50 line) is estimated to have declined in 2021 to 49.2 percent, still above the pre-crisis level. However, the middle class (US$13–US$70 per day in 2011 purchasing power parity) recovered to its precrisis level of 17.9 percent in 2021, after a 3.6 percentage point fall at the onset of the pandemic in 2020. Vaccinations helped slow the spread of COVID-19 and support the reactivation of the domestic activities in 2021. As of the end of April 2022, 49 percent of the population was fully vaccinated.

Growth is expected to moderate in line with potential GDP growth. Real GDP growth is expected to moderate to an average annual rate of 3.5 percent over the medium term, slowly converging to its potential as global demand tempers and crisis support is phased out (table 1.1). The slowdown in COVID-19 incidences together with the effective vaccine rollout is expected to strengthen domestic activities. Honduras expects the vaccination rate to reach 81.5 percent by the end of 2022 and vaccines to be widely available in 2023. Economic growth is expected to be driven by contained private consumption owing to a slow recovery in the labor market. Remittances will continue to fuel domestic consumption, albeit at a slower rate because of stabilization in US growth and higher commodity prices amid the war in Ukraine. The agriculture sector is expected to recover, but will remain vulnerable to US import demand and climate-induced natural hazards. The service sector is expected to grow in line with private consumption in 2022, supported by increasing domestic activity amid the vaccination rollout. Amid supply chain shortages, the manufacturing sector is expected to grow 1.3 percent during 2022. The poverty rate (US$5.50 line) is expected to decline to 46.8 percent by 2024.

High inflationary pressures are expected to maintain an above target average inflation in 2022 before receding to below 5 percent in 2023. Although being contained by a relatively stable exchange rate, inflation accelerated to 6.9 percent year over year in March 2022—above the BCH’s target band (4 percent ± 1 percent)—amid higher food and energy prices and strong domestic demand. Inflationary pressures have been reinforced by the pandemic-related supply chain problems and the conflict in Ukraine. Higher food and gasoline prices pose a risk to poverty reduction as they account for a higher share of household expenditure at the bottom of the distribution. The BCH is expected to begin monetary tightening in the near term to ensure that inflation remains anchored within the target band over the medium term.

Honduras’s external position is expected to remain strong, supported by remittances and external non-debt financing. After registering a historical surplus of 2.9 percent of GDP in 2020
### Table 1.1. Selected Macroeconomic Indicators and Projections in Honduras, 2015–24

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<td>Non-interest revenues and grants</td>
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<td>−0.9</td>
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<td>1.2</td>
<td>2.8</td>
<td>3.1</td>
<td>2.9</td>
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Sources: World Bank staff estimations based on data from the Central Bank of Honduras and Ministry of Finance as of March 2022.

Note: p = preliminary; f = forecast.
amid strong contraction in imports, the current account reversed to a deficit in 2021 and expected to hover around 4 percent over the medium term. Risks to external stability are expected to be mitigated to a certain extent by FDI, which largely finances the current account deficit. Aided by strong remittances and external financing, international reserves are expected to remain solid over the medium term, comfortably covering about 8 months of nonmaquila imports.

**Risks to the growth outlook remain on the downside.** Extreme weather events could lead to infrastructure damages, large agricultural losses, lower exports, and growth. A slower global recovery amid the prolonged pandemic and new COVID-19 waves and related supply chain shortages could weaken Honduras’s pace of recovery. Global uncertainty related to the Russian Federation’s invasion of Ukraine can lead to financial outflows or additional inflationary pressures (that is, energy and food). Growing inflation pressures or an accelerated normalization of US monetary policy may call for the BCH to further expedite interest rate increases. Domestically, a weak legislative position in the ruling party and political fragmentation could slow progress on fiscal, social, and structural reforms and, along with budget execution issues, weaken growth and pose a risk to macroeconomic stability by delaying reforms. The persistent deficit of the National Electric Power Company (ENEE) threatens Honduras’s fiscal position. Cumulatively, these risks could negatively affect the economy, especially poor households that are highly dependent on agriculture outputs and remittance income. These shocks could also add excess fiscal pressures, resulting in further fiscal slippages, which could derail efforts to contain debt growth and further crowd out private sector–led growth after the crisis.

### 1.2 Evolution and composition of government revenues

**Honduras collected significantly more tax revenues than structural and aspirational peers.**

Total revenues and grants averaged 31.5 percent of GDP between 2014 and 2019 and were about 15.2 percentage points higher than Honduras’s aspirational peers, almost 9.9 percentage points above its structural peers, and 3.4 percentage points above the Latin America region average (figure 1.7). Honduras’s tax burden was the highest among Central American countries in 2019, relying on slightly higher rates for VAT and personal income taxes, while keeping the corporate income tax at 25 percent, the lowest in the region (figures 1.9–1.14). Although Honduras’s tax revenue to GDP is well above its structural and aspirational peers, there is potential for further tax revenue mobilization, especially given Honduras’s high informality rate of 74.5 percent of employment.

**Total government revenues relative to GDP remained relatively stable between 2014 and 2019; however, the composition of revenues changed.** Total nominal revenue of the NFPS grew on average by 9.0 percent per year, roughly in line with average nominal GDP growth of 8.5 percent, and amounted to 31.2 percent of GDP in 2019, unchanged from 2014. Key changes to the composition of revenues were as follows:

- Nominal tax revenue grew faster than nominal GDP and total revenue, at an average of 12.0 percent per year. The tax-to-GDP ratio hence increased by 1.6 percent of GDP between 2014 and 2019, from 16.7 percent in 2014 to 18.3 percent in 2019 (figure 1.8).
**Figure 1.7. Honduras’s Revenue Relative to Peers**

Source: World Bank staff calculations based on data from the Honduran Ministry of Finance.

Note: LAC = Latin America and the Caribbean.

**Figure 1.8. Revenue Composition**

Source: World Bank staff calculations based on data from the Honduran Ministry of Finance.

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**Figure 1.9. Honduras’s Tax Revenue Relative to Peers and LAC**


Note: LAC = Latin America and the Caribbean; * = data on Cambodia starting in 2002.

**Figure 1.10. Honduras’s Tax Revenue Composition**

**Figure 1.11. Honduras’s Tax Revenue Relative to Peers and LAC, Averages of 2014–19**

![Graph showing tax revenue relative to peers and LAC](image)


**Figure 1.12. Income Tax Revenue as a Percentage of GDP: Honduras and Peers**

![Graph showing income tax revenue as a percentage of GDP](image)


Note: CA = Central America; DR = Dominican Republic. *Lao People’s Democratic Republic data start in 2006. **Benin data start in 2001 and Cambodia data start in 2002.

**Figure 1.13. Taxes on Goods and Services, Honduras and Peers (2014–19)**

![Graph showing taxes on goods and services](image)


**Figure 1.14. Tax and GDP versus GDP per Capita (2014–19)**

![Graph showing tax and GDP versus GDP per capita](image)

Source: Staff estimates based on World Revenue Longitudinal Data (WoRLD), International Monetary Fund, [https://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78](https://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78), and World Development Indicators.
Nominal revenue from direct taxes grew faster than from indirect taxes, at 9.7 percent on average compared with 8.7 percent for the latter.

VAT revenue was the fastest-growing tax item, with nominal revenue increasing by 13.5 percent on average per year since 2014, to 7.0 percent of GDP in 2019. The second-fastest-growing tax item was income tax revenue followed by trade tax revenue, with nominal revenue growing on average by 10.5 and 10.2 percent annually.

Increased income tax and VAT collection was facilitated by the 2014 tax reform, which created the alternative minimum tax and increased the VAT rate. The creation of a new tax administration (Servicio de Administracion de Rentas—SAR) in 2015 and the use of anti-money laundering legislation to prosecute tax fraud also contributed to increased tax income.

The fastest-growing nontax revenue item was social security contributions, which increased by about 9.0 percent on average during 2014–19, followed by sales of goods and services, which grew at an average 6.4 percent. Relative to GDP, the latter nevertheless accounted for nearly double the income from social contributions, at around 6.0 percent of GDP in 2019.

Because of progress in tax collection, the share of taxes in total revenues rose to 59 percent in 2019. Indirect taxes composed the larger share of tax revenues with 11.9 percent of GDP in 2019, despite growing at a slower pace, reflecting the economic importance of consumption. Direct taxes accounted for roughly 6.5 percent of GDP in 2019. VAT revenue was the largest tax item, accounting for 7.0 percent of GDP, followed by income tax revenue of 5.6 percent of GDP. Among nontax revenues, sales of goods and services contributed 5.8 percent of GDP and social security contributions were 3.4 percent of GDP.

Changes in the tax code and widespread tax exemptions and amnesties nevertheless challenge the effectiveness of the tax system. The 2017 phasing out of the minimum income tax and changes to the tax code, including the increase in gross income exempted from the corporate income tax, have negative effects on tax collection in the medium term and increased the regressivity of the tax system. Honduras also has one of the highest levels of tax expenditures in the world at 6.8 percent of GDP—about 60 percent of which is explained by exemptions associated with VAT and special income tax regimes and excises (box 1.2). These features undermine the revenue base and the efficiency of the tax system, do not promote transparency or predictability, and increase tax avoidance. A draft bill to streamline tax exemptions was submitted to Congress that eliminated exemptions in areas such as rural tourism, special tourism zones, and renewable energy.

The high reliance on indirect taxation likely disproportionally affects the country’s poor. The abolishment of the minimum income tax and numerous exemptions, as well as a comparably low corporate income tax rate, benefit incomes in the top quartiles of the distribution. Indirect taxes, however, are more broadly applied and affect the poor more, who spend a larger proportion of their income on basic consumption goods, such as food. Strong reliance on indirect taxation additionally exposes the government to potential revenue shortfalls in the case of economic downturns as experienced after 2019.

The COVID-19 crisis and hurricanes led to a significant drop in tax revenue in 2020 amid reduced economic activity. Estimates suggest that total nominal tax revenue declined by nearly
Box 1.2. Tax Credits and Incentives in Honduras, 2019

Employment: Companies or individuals creating five or more new employment positions receive tax credits equal to 10 percent of the annual minimum salary for each new employee.

- **Export promotion law.** Tax benefits consist of tax exemptions for export industries, exemption from export tax for all nontraditional exports, duty-free treatment for imported raw materials and components, and a 10-year grace period on income tax for industries exporting nontraditional goods to international markets. Eligible for the benefits are individuals and companies using machinery and equipment to assemble or transform products or render services for exportation to countries that are not in Central America. A temporary import law applies to companies operating outside the country’s designated free zones but still exporting 100 percent of production to markets outside the Central American region. The law provides for duty-free import of the required equipment and materials.

- **The Law of Free Trade Zones.** Companies operating in the designated free-trade zones (FTZs) are exempt from income tax, sales tax, custom duties, and some municipal taxes qualify. Other general incentives granted in a free zone are unrestricted currency conversion; duty-free import of all production machinery, other equipment, fixtures, spare parts, raw materials, and supplies; unrestricted repatriation of profits and capital at any time; and others.

- **Export processing zones (ZIPS).** ZIPS were created to promote manufacturing and service industries exclusively devoted to exports. A ZIP company enjoys exemptions from export tax for all nontraditional exports, drawback or duty-free treatment for imported raw materials and components, and exemption from income tax for 20 years and from municipal taxes for 10 years.

- **The call center and business processing operations (BPOs) promotion law.** This law provides a tax holiday on import of tools, parts, accessories, furniture and office equipment, and all goods involved with a company’s active business. It also provides an income tax holiday on revenue from all the business activities carried out within the FTZs. The regulations for the FTZs consider international service companies (for example, BPOs, call centers, contact centers, and shared service centers) that will have the same tax exoneration provided by this regime.

- **Renewable electricity generation.** Individuals and companies engaged in electricity generation from renewable energy sources enjoy sales tax exemption, exemption of all import duties, income tax exemption for a 10-year period for projects generating 50 megawatts and more, and exemption from withholding tax levied on foreign persons or companies performing services related to the energy project.

- **Investment promotion.** Investment projects that are of priority interest may be granted an amortization period for up to five years for the preoperative expenses

(continued)
20 percent. Because of lockdowns domestically and in key trading partners, trade tax revenue is expected to have registered the biggest nominal decrease in 2020, by more than 24 percent. Income tax revenue and VAT collection are estimated to have decreased by 20 percent and 10 percent, respectively. Finally, property tax collection decreased by roughly 16 percent, yet amounted to only a minor share of tax revenue. Other nontax revenue decreases were less pronounced, with estimates suggesting that social security contributions contracted by about 3 percent.

The comparably large decrease in tax collection in 2020 shifted the revenue composition back toward nontax revenues. The share of taxes in overall revenues decreased from 59.0 percent in 2019 to 55.0 percent in 2020, or 15.5 percent of GDP, which was only 77.0 percent of the budgeted amount. The share of indirect taxes in overall revenue decreased by roughly 2.6 percentage points, to 9.9 percent of GDP. Direct tax decreases were less pronounced: 0.8 percentage points to 5.6 percent of GDP. Accordingly, the share of nontax revenue increased to roughly 45.0 percent of overall revenue, or 12.5 percent of GDP.

Future revenue mobilization efforts in Honduras should improve the tax system by increasing tax efficiency, governance, and compliance. To avoid negative growth effects through higher direct tax rates and negative distributional effects through even higher taxation of consumption, Honduras could broaden the tax base, eliminate tax exemptions, enhance progressivity, and strengthen enforcement and administration. Boosting tax revenue could be achieved by increasing the progressivity of direct taxation aimed at addressing fairness and equity concerns, which could boost compliance and build taxpayers’ trust. In 2019, the Ministry of Finance announced a draft decree amending the rules on tax incentives and exemptions. Congress also approved the use of electronic notifications to taxpayers, an important step toward increasing

- **Tax amnesty program.** This program allows taxpayers to file tax returns and information returns and to modify returns already filed without the imposition of penalties, surcharges, and interest on taxes incurred up to December 31, 2017. The incurred tax obligations should correspond to tax years 2013, 2014, 2015, 2016, and 2017 (the amnesty period), whereas customs obligations should correspond to tax years 2014, 2015, 2016, and 2017. The deadline to apply to this program has been extended periodically. However, the authorities plan not to issue new tax amnesties according to the International Monetary Fund’s 2019 Article IV Consultation.

- **Tax incentives for small and medium enterprises (SMEs).** Incentives are given to SMEs that are formalized during a 12-month period that started November 28, 2018. The tax incentive, given for a period of five years, is the exemption from income tax, net asset tax, solidarity contribution, and municipality business license tax.

Box 1.3. Tax Policy in Honduras: Key Challenges

The tax base of the consumption taxes is narrow with many exemptions, mainly in the value added tax (VAT), which accounts for the majority of tax expenditures. The VAT exemptions include the special regimes described in box 1.1, plus exemptions for basic food products, pharmaceuticals, agricultural products, and education and health services, among others. In addition, there is VAT preferential tax regime for small businesses with a turnover in the preceding year lower than L 250,000. Under this preferential regime, small businesses do not charge output sales tax on their supplies and therefore do not collect VAT. In addition to the VAT, excise taxes are levied on various goods at different rates; however, some items and transactions are exempted based on the special regimes (see box 1.2). Imports are subject to ad valorem duties ranging from 5 percent to 20 percent. The average applied tariff rate is 2.8 percent. According to the Heritage Foundation’s 2019 Index of Economic Freedom, additional barriers impede imports of certain agricultural goods. Consequently, the regulatory systems may act as barriers to foreign investment.

The 2017 tax code weakened the coercive powers of the new tax authority (Servicio de Administracion de Rentas; SAR), mainly with the framework to control exemptions, and made noncompliance notification procedures to taxpayers less efficient. Currently, the Ministry of Finance (SEFIN) is in charge of the operation management of tax exemptions, including the issue of the exempted VAT purchase orders and credit notes. A taxpayer takes 33 hours to comply with the VAT and waits 54 weeks to obtain the refund, which is considerably higher than the Latin America and the Caribbean region average and its regional comparators. This circumstance shows that procedures for VAT refunds are not functional. That is why it is important to transfer all verification procedures for the tax exemptions from SEFIN to SAR. Best practice advises that the management of tax exemptions is better performed by the tax administration with its better expertise and direct access to VAT-relevant information (that is, VAT returns).

Regulations on the monotax introduced by the 2017 tax code have not been issued yet, therefore attention should be given to determining the eligibility threshold. A monotax was introduced by the 2017 tax code to replace the obligation to pay any tax on direct income. Organizations in the social sector of the economy, other economic and professional sectors, and those sectors that carry on nonprofit economic and civil activities will be subject to the monotax. When designing such a regime, attention should be given to incorporating the lessons learned in other countries, especially small open economies, on dealing with common pitfalls of disincentives to firm growth and tax bunching. Therefore, the determination of the threshold to access this regime is relevant when issuing the regulations.

Honduras’s shift toward a tax system based on the territoriality principle is prone to base erosion owing to tax arbitrage. One of the key changes introduced by the 2017 tax code was the transition from worldwide taxation to the territorial system. This change means that only income derived from Honduran sources are taxable in Honduras. Without clear rules to prevent base erosion and profit shifting, this system creates an incentive for multinationals to manipulate their financial flows to low-tax jurisdictions. Even though Honduras covers withholding taxes to nonresidents on their Honduran-source income, no other measures are in place to backstop arbitrage by multinationals, such as provisions for controlled foreign companies, thin capitalization, and general antiavoidance rules. Transfer pricing rules are the only intragroup rules.
tax compliance. Progress has been made in core areas, including the registered taxpayer base, voluntary compliance, the filing and payment of declarations, and accurate reporting in tax declarations. Authorities require a strategy to raise revenue, including by revisiting exemptions and examining significant shortcomings in revenue management, accountability and transparency, and administrative practices (see box 1.3).

**The property tax base in Honduras is little explored.** Property and land taxes are relatively effective local taxes, and ideally have a broad but simple tax base, where the tax base and rates are adjusted regularly to reflect developments in the market value. This approach should be aided by modern administrative support systems, including up-to-date land and property registration in central cadastres and a strong evaluation profession. Owing to administrative and institutional issues, they generate little revenue in developing countries, including Honduras, where the property tax on average generated 0.31 percent of GDP tax revenue from 2014 to 2019, which is similar to the amount generated by its peers. The property tax rate varies depending on the location of the property, with an average of 0.5 percent; in addition, each municipality sets specific rates annually.

### 1.3 Evolution and composition of government spending

Total public expenditure in Honduras was in line with the Latin American region average, but substantially above aspirational and structural peers (figure 1.15). Despite rationalizing expenditure during 2014–19, Honduras spent more than peer countries, on average 32.8 percent of GDP. Honduras total spending in 2019 stood 13.0 percent of GDP above aspirational peers and 7.3 percent of GDP above structural peers. Spending, however, was in line with the regional average in 2019 owing to stronger decreases in Honduras’s spending than in the rest of the region. The Honduran government’s final expenditure was below the LAC regional average during 2016–19, however, on par with the structural peers (figure 1.16).

Total public expenditure relative to GDP decreased between 2014 and 2019, and the composition shifted slightly toward capital spending (figure 1.17). Total nominal expenditure grew at an average annual rate of 5.6 percent, substantially below average nominal GDP growth. As a result, the share of expenditure relative to GDP decreased by 3.1 percentage points between 2014 and 2019, from 35.2 percent of GDP to 32.1 percent of GDP. Key changes to the composition of expenditure were as follows:

- Nominal current expenditure grew at a lower average rate than overall expenditure and GDP, at 5.5 percent per year. The share of current expenditure relative to GDP hence decreased by 2.7 percentage points, from 29.2 percent in 2014 to 26.5 percent in 2019.
- Nominal expenditure on wages and salaries, the largest expenditure item, grew at the slowest rate, 4.5 percent on average per year and drove the prudent current expenditure dynamics. The share of wages and salaries relative to GDP decreased accordingly, by 1.4 percentage points from 12.7 percent to 11.3 percent.
- Nominal interest expenditure, however, grew on average by around 11.0 percent, faster than overall and current expenditure, as well as GDP. Relative to GDP, interest expenditure remained relatively constant at 2.3 percent.
Honduras increasingly borrowed from external sources on commercial terms, including the 2013 and 2017 Eurobond issuances totaling US$1.7 billion. Interest service was split evenly between domestic and external sources, both accounting for roughly 1 percent of GDP.

Nominal capital spending grew faster than current spending, on average by around 6.3 percent. Relative to GDP, capital spending nevertheless decreased owing to lower average nominal growth than GDP, from 5.9 percent in 2014 to 5.5 percent in 2019.

Adherence with the fiscal responsibility law allowed to reduce the current expenditure burden by 2019. Current expenditure relative to GDP dropped to 26.5 percent in 2019, from 29.2 percent in 2014. The more favorable expenditure position in 2019 is mainly the result of continued adherence with the expenditure rule laid out in the FRL, effectively limiting recurrent spending. Although capital expenditure relative to GDP decreased as well, its share in total spending increased from 16.8 percent of total expenditure in 2014, to 17.3 percent in 2019.

High current spending, nevertheless, constrained public investment, affected the allocation efficiency of spending, and likely affected long-term growth prospects. The government managed to reduce the wage bill to around 11.3 percent of GDP in 2019 (down from 12.7 percent in 2014); however, it continued to be the largest expenditure item (figure 1.17). Wages in the education and health care sectors account for the bulk of sectoral wage spending. The relative share of wages in public expenditure has been highest in decentralized public institutions, where they accounted for around 68 percent of public expenditure in 2019, followed by the central government and local governments, where wages accounted for 35 percent and 22 percent of public expenditure, respectively. Expenditure on goods and services were the second-largest expenditure item, accounting for 8.7 percent of GDP in 2019.
High expenditure to support the financially unviable ENEE crowded out more productive spending. ENEE accounts for 91 percent of nonfinancial state-owned enterprise (SOE) liabilities. Persistent underperformance has required the government to redirect substantial funds to the company. Whereas data on transfers are limited, ENEE accounts for 95 percent of outstanding loan guarantees and more than 90 percent of on-lending. The 2020 Eurobond issue of US$600 million was used entirely for the repayment of ENEE liabilities.

Public investment decreased markedly over time but recovered recently compared with 2011–15 (figure 1.19). Public investment in developing economies is estimated to have a larger effect on growth than in developed economies. Historically, Honduras’s public investment exceeded that of regional and aspirational peers. Rigid current spending, however, led to lower investment spending. Average investment amounted to 3.2 percent of GDP between 2014 and 2019. Whereas this constitutes a slight increase compared with the preceding years and is in line with peers, it lies substantially below historical investment rates. Eighty one percent of budgeted investment spending was executed in 2019 (figure 1.20). Low public investment limits the government’s capacity to provide adequate infrastructure, thus constraining growth. Similarly, spending on education and health care decreased between 2014 and 2019.

Rigid expenditures can hinder shifting public expenditure toward a more growth- and development-friendly allocation and may jeopardize resistance to economic shocks. Rigid expenditure are those items that are hard to adjust over a short period because of institutional constraints, including, for example, public wage spending, pension spending, and interest expenditure. Authorities have only limited discretion in adjusting such expenditure in the short term or in the case of unexpected economic shocks. Table 1.2 provides a classification of expenditure items and their rigidity.
Rigid expenditure in Honduras, in particular spending on public wages, accounted for more than half of total expenditure as of 2019. Wage spending has been large for the education and health care sectors, despite efforts by the government to reduce it (for more detail, see chapter 3). Large and rigid budget allocations for public wages have limited spending allocation efficiency in Honduras and led to more inefficient public spending. This affects the ability of the government to effectively plan and control expenditures; to recover from economic shocks, which is crucial for keeping public finances...
on a sound footing; and to gradually reorient public spending toward growth-enhancing efforts. It could also have important effects on fiscal performance by increasing the country’s financing needs, increasing the probability of fiscal distress, and reducing the ability to carry out fiscal adjustment.

There is substantial space to switch from inefficient government spending to spending that contributes to growth. The estimated inefficiencies in procurement, the civil service, and targeted transfers in Honduras represent an average amount of waste of 4.6 percent of GDP (see figure 1.21). This is higher than the average for LAC, higher than current average regional spending on health (4.1 percent), and almost as high as average spending on education (4.8 percent). Honduras has the second-largest wage bill inefficiency in the region (after El Salvador), which implies that part of this wage bill premium is not driven by skills but by higher union density in the public sector and political economy considerations. Targeting errors or leaks in social programs are relatively low in Honduras as are inefficiencies in transfers, including energy subsidies, cash transfers, noncontributory pensions, and tax expenditures on the nonpoor. However, inefficiencies in public procurement, including the purchase of goods and services and capital equipment, represent a significant inefficiency risk in Honduras.

Public expenditure increased only modestly in 2020 in response to the COVID-19 shock. Nominal total expenditure increased by 0.4 percent in 2020. Yet, because of the substantial drop in nominal output, total expenditure relative to GDP increased by 1.7 percentage points, to 33.8 percent of GDP. Total expenditure was suppressed by a 16.3 percent reduction of nominal capital spending in 2020, while nominal current spending increased by 3.9 percent. Nominal interest expenditure recorded the strongest increase among all expenditure items, 18.4 percent, owing to increased COVID-19-related financing needs. As a result of these dynamics, the share of current spending is projected to have increased again in 2020 and 2021, to 28.9 percent and 27.1 percent of GDP, respectively. The share of capital spending contracted to 4.9 percent of GDP in 2020 but is projected to have recovered in 2021 to 6.1 percent of GDP.

Important challenges also remain on social spending. The Conditional Cash Transfers (CCT) program in Honduras and the targeting system have improved and mitigated the impact of the COVID-19 crisis. The social registry managed by the National Center for Information on the Social Sector (Centro Nacional de Información del Sector Social/CENIIS) was established in 2014 to identify all potential social program beneficiaries. This social registry enabled a rapid response during the COVID-19 pandemic, identifying beneficiaries for emergency programs. During the pandemic, the CCT program introduced innovations, including digitalizing its payment system through the development bank (BANPROVI). Nevertheless, weak institutional capacity continues to hamper the ability of public agencies to foster education, health, and labor skills among the poor, curbing the accumulation of human capital and perpetuating economic inequality.

The composition of public spending is critical for growth and can help mitigate the contractionary effects of fiscal discipline. Whereas fiscal consolidation tends to be contractionary, the size of the output fall depends on the behavior of public investment relative to public consumption. When public investment is cut more substantially than public consumption and
thus its share in public expenditures decreases, enhanced fiscal discipline tends to have a larger contractionary effect. In contrast, safeguarding public investment from budget cuts compared with public consumption can neutralize the contractionary effects of fiscal consolidations and can even spur output growth over the medium term (figures 1.21 and 1.22). In the past, Honduran authorities have had limited success in prioritizing growth-enhancing investment spending over current expenditure, particularly on public wages. A uniform reduction of 1.1 percentage points of GDP of public consumption and investment each would imply a substantially larger contribution of investment to consolidation than from current spending, 32.0 percent versus 3.9 percent, respectively. To ensure a growth-friendly convergence with the FRL going forward, the rearrangement of the total expenditure should come through public consumption, while public investment should be prioritized.

### 1.4 Overall fiscal balance, financing, and stock of public debt have deteriorated

**Compliance with the FRL significantly reduced fiscal imbalances in the run-up to the 2020 twin shocks.** The government implemented a comprehensive fiscal consolidation program, anchored in the FRL, complemented by reforms in tax policy and tax administration, as well as public financial management, structural reforms of SOEs, and financial sector policies (see appendix A). After 2013, the NFPS deficit, which includes all SOEs, decreased by 6.3 percent of GDP from 7.1 percent in 2013 to 0.9 percent in 2019. The structural deficit decreased from 7.1 percent in 2013, to 0.8 percent in 2019, as the government consistently overperformed compliance with the FRL (figures 1.22 and 1.23; table 1.3). Fiscal consolidation was achieved by current expenditure cuts and increased tax collection, which weighed on growth (see box 1.4) and

![Figure 1.22. Nonfinancial Public Sector Deficit and Fiscal Responsibility Law Limit](image)

**Figure 1.22. Nonfinancial Public Sector Deficit and Fiscal Responsibility Law Limit**

- NFPS balance
- NFPS deficit limit
- FRL introduced
- FRL escape clauses triggered

**Figure 1.23. Nonfinancial Public Sector Revenue and Expenditure**

- Total revenue
- Total expenditures
- Elections

**Sources:** Banco Central de Honduras; Honduras Ministry of Finance; World Bank staff estimates.

**Note:** FRL = fiscal responsibility law; NFPS = nonfinancial public sector.
poverty reduction efforts as evidenced by relatively stagnant national poverty line between 2014 and 2019. On the contrary, public investment might have supported growth and employment; however, this effect is unknown.27

However, challenges for fiscal sustainability stem from the high exposure to risks from explicit and implicit contingent liabilities. Authorities reported in 2021 that the exposure fluctuates between 35 percent and 70 percent of GDP, depending on assumptions.28 A substantial part of the risk stems from guarantees and on-lending to ENEE, the state electricity company that received 95 percent of the outstanding portfolio. ENEEs structural weaknesses and continued losses absorb substantial public funds and pose significant risk to fiscal sustainability. ENEE’s fiscal deficit increased rapidly between 2016 and 2019, reaching 1.1 percent of GDP in 2021 and posing the key challenge to meeting the FRL targets.

Fiscal policy has been acyclical, especially considering public investment. Figure 1.24 shows the cyclical orientation of fiscal policy in Honduras that is captured by changes in the structural

| Table 1.3. Main Fiscal Indicators 2016–21, as Percentage of GDP |
|---------------------|------|------|------|------|------|------|
| Revenues            | 32.3 | 31.6 | 31.4 | 31.2 | 28.0 | 30.2 |
| Direct revenues     | 6.7  | 6.3  | 6.7  | 6.5  | 5.6  | 5.4  |
| Indirect taxes      | 12.2 | 11.9 | 11.7 | 11.9 | 9.9  | 12.5 |
| Interest revenues and dividends | 1.9  | 1.4  | 1.4  | 1.6  | 1.5  | 1.7  |
| Contributions soc. sec. | 3.4  | 3.6  | 3.6  | 3.7  | 3.6  | 4.0  |
| Sales and services  | 5.7  | 6.0  | 5.5  | 6.2  | 4.9  | 5.9  |
| Other revenues      | 2.4  | 2.5  | 2.5  | 1.5  | 2.5  | 0.7  |
| Expenditures        | 32.8 | 32.5 | 32.3 | 32.1 | 33.5 | 33.8 |
| Goods and services  | 8.1  | 8.3  | 8.2  | 8.7  | 9.2  | 9.2  |
| Wages               | 11.3 | 11.1 | 11.2 | 11.3 | 12.2 | 11.6 |
| Interest payments   | 2.7  | 2.2  | 2.4  | 2.6  | 2.8  | 2.9  |
| External            | 1.0  | 0.9  | 1.1  | 1.4  | 1.2  | 1.1  |
| Domestic            | 1.8  | 1.4  | 1.2  | 1.3  | 1.7  | 1.8  |
| Capital expenditures | 5.9  | 6.3  | 6.4  | 5.5  | 4.9  | 5.6  |
| Other expenditures  | 4.7  | 4.5  | 4.1  | 4.0  | 4.4  | 4.5  |
| Government balance  | -0.5 | -0.8 | -0.9 | -0.9 | -5.5 | -3.7 |
| Primary balance     | 0.3  | 0.1  | 0.0  | 0.2  | -4.2 | -2.5 |
| General government debt | 40.1 | 40.1 | 42.1 | 43.5 | 54.1 | 53.1 |
| External debt       | 28.4 | 30.5 | 30.9 | 31.1 | 40.0 | 39.8 |
| Domestic debt       | 11.7 | 9.6  | 11.2 | 12.4 | 14.1 | 13.3 |

Sources: World Bank staff estimations based on data from the Ministry of Finance and the Central Bank of Honduras.
**Box 1.4. Understanding the Effects of Fiscal Consolidation on GDP Growth**

The consensus in economic literature is that fiscal consolidations (FC) are contractionary in the short term for both advanced and developing countries. Box figure 1.4.1 shows the change in cyclically adjusted primary balance (CAPB) in Honduras for the period 1990–2021. Two episodes of outstanding FC can be observed: (a) the first between 1994 and 1995 where the CAPB accumulated an improvement of 5.0 percentage points of GDP in two years, and (b) the second during 2014 and 2016 when the CAPB improved by percentage 7.3 points of GDP in three years. Further, if Honduras’s overall fiscal balance to be reduced in the next two years from −3.7 percent of GDP in 2021 to −1.0 percent of the GDP in 2023, an expected improvement in the overall fiscal balance is 2.6 percentage points of GDP in two years.\(^a\) The impact of these types of fiscal episodes on GDP can be estimated by adopting the single-equation approach.\(^b\) Box figure 1.4.2 presents the estimated effect of an average improvement (that is, 2.5 percentage points of GDP) in the fiscal balance on the real GDP level in Honduras over three years. Hence, the road to closing the fiscal deficit reduces output by 0.5 percent on the first year and by 0.4 percent after two years.

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**Figure 1.4.1. Change in CAPB, percentage points of GDP**

![Graph showing change in CAPB, percentage points of GDP](image)

**Figure 1.4.2. Output Effects of Fiscal Consolidations in Honduras**

![Graph showing output effects of fiscal consolidations](image)

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*Sources:* Martin Ardanaz et al., “Structural Fiscal Balances in Latin America and the Caribbean” (IDB Working Paper Series 579, Inter-American Development Bank, Washington, DC, 2015), and World Bank staff calculations based on data from Honduras Ministry of Finance.

*Sources:* World Bank staff elaboration based on the International Monetary Fund's World Economic Outlook; Martin Ardanaz et al., “Structural Fiscal Balances in Latin America and the Caribbean” (IDB Working Paper Series 579, Inter-American Development Bank, Washington, DC, 2015); and data from SEFIN.

*Note:* Year = 0 denotes the year of FC. Dotted lines indicate 90 percent confidence interval.

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*\(^a\)* Although this improvement in the fiscal balance in Honduras has to do with achieving the targets imposed by the FRL, this type of fiscal episodes may not be considered a traditional FC.

primary balance (fiscal balance) and output gap (a measure of business cycle) for 2015–24. No clear relationship exists between both variables over this period suggesting either procyclical or acyclic fiscal policy, and no indication for countercyclical fiscal policy. Moreover, whereas empirical evidence suggests procyclicality, it is not statistically significant at the 10 percent confidence level, reinforcing the idea of the fiscal stance being acyclical in Honduras (figure 1.25). Where capital spending appears to be acyclic, current spending is procyclical.

Acyclic policy and relatively low investment rates have limited the government’s capacity to maneuver through unexpected shocks. It has led to cuts in public investment or budget reallocations during economic contractions. Rates of domestic public and private investment in Honduras have consistently been lower than those in its structural and aspirational peer countries. There is a need to find a balance between the necessary fiscal adjustments and a fall in public investment small enough not to lower growth and, consequently, the present value of revenues. Transitioning to a more countercyclical fiscal policy would stabilize the cycles, support fiscal sustainability, and enable the government to accumulate reserves of assets to respond to external shocks.

As a result of the COVID-19 pandemic and hurricanes, Honduras’s public deficit and debt increased. The NFPS deficit widened to 5.5 percent of GDP in 2020, up from 0.9 percent in 2019. The higher deficit was driven by a 2.8 percentage points contraction in tax revenues as a result of
the contraction in economic activity and 1.7 percentage points increase in spending, mainly explained by public salaries (0.9 percentage points) and services (0.5 percentage points). Public investment declined by 0.4 percent of GDP. The hurricanes also exacerbated the liquidity pressures the pandemic already imposed on ENEE and resulted in increased arrears to electricity generators.\textsuperscript{32} Gross public debt increased to 54.1 percent of GDP in 2020 (compared with 43.5 percent in 2019), with the fall in GDP accounting for 70.0 percent of the increase in external public and publicly guaranteed (PPG) debt. External borrowing accounted for the bulk of 2020 financing, including a sovereign bond placement (US$600 million)\textsuperscript{33} and multilateral loans (US$1,552.7 million).

The fiscal deficit continued to be high in 2021, as reconstruction and health needs were significant. In line with the extended FRL escape clause, the NFPS deficit for 2021 is estimated at 3.7 percent of GDP, bringing total NFPS debt to 53.1 percent of GDP, below structural peers, but in line with aspirational peers (figure 1.26). Moreover, Honduras’s fiscal package\textsuperscript{34} in response to the COVID-19 pandemic was relatively small compared with other LAC economies (figure 1.27 and appendix C). PPG external debt accounted for about 60.0 percent of outstanding NFPS debt. Honduras is expected to continue receiving external financial support while gradually returning to the FRL target of 1.0 percent NFPS deficit. The required fiscal tightening is challenging and is expected to be supported by the gradual unwinding of pandemic support, budget reallocations, and revenue growth aided by the economic recovery and revenue mobilization measures. Compliance with the FRL is expected to stabilize public debt over the medium term.

The 2021 Low-Income Country Debt Sustainability Analysis (DSA) assessed Honduras at low risk of overall and external debt distress. Public debt remains sustainable and the debt service remains relatively low. This assessment holds despite the activation of the FRL’s escape clause.
Clause and temporary higher fiscal deficits and assumes the return to adherence with the FRL by 2023. All external and overall debt burden indicators remain comfortably below their respective thresholds under baseline assumptions (figure 1.28 and appendix D). Honduras’s track record of compliance with the FRL provides confidence that the response to the pandemic will not jeopardize debt sustainability. However, contingent liability risks remain high, including those related to ENEE and exogenous shocks, in particular to exports. Mitigating these risks is critical to maintain debt sustainability.

**Curbing the debt trajectory and aiming for a return to a primary balance surplus over the medium term remains key once the impacts of the twin shocks abate.** Reducing public debt remains challenging as the primary balance required to stabilize the debt-to-GDP ratio within five years differs significantly from the balances that are likely in the short and medium term. Fiscal balance deterioration consequent upon the pandemic and hurricanes limits the capacity to
use fiscal levers to address the challenges of recovery and reconstruction, calling for both a continuation of the orthodox management of the fiscal situation of the country, additional resources mobilization, and access to concessional funds for reconstruction. On the expenditure front, promoting improvements in public expenditure efficiency, effectiveness, and equity is critical to improve service delivery but also to reduce budget rigidity.

1.5 Strengthening fiscal resilience

The 2020 twin shocks underscored the fragility of economic and poverty gains and Honduras’s exposure to potential reversals. The response to the recent crises in Honduras has benefited from the country’s prudent macroeconomic management and improvements in disaster knowledge, preparation, and response, including in disaster risk financing. However, resilience remains low as evidenced by the devastating impacts of twin shocks. The crises of 2020 followed the same unfortunate pattern and affected Honduras more than other countries in the region amid a more challenging political and governance environment. Climate change is expected to intensify the frequency of extreme weather events and exacerbate their impacts, calling for the need to strengthen resilience, including the fiscal capacity to address the impacts of shocks.

The crucial challenge faced by Honduran policy makers is to reinforce fiscal resilience to achieve, to protect, and to sustain income and poverty gains. It is important for the country to preserve macro-fiscal stability and fiscal discipline, and to advance on the implementation of structural reforms. Strengthening fiscal resilience will also require Honduras to implement policies that could help address fiscal constraints and safeguard critical investment, basic services, and social assistance for the poorest. Policies to strengthen fiscal resilience should include the following:

- **Preserving fiscal discipline** by compliance with the FRL. This could be supported by the gradual unwinding of pandemic support and post-hurricanes reconstruction, budget reallocations, revenue growth aided by the economic recovery, revenue mobilization measures, and strict spending controls.
- **Strengthening tax policy and tax administration, including revenue management**, to help improve the efficiency and equity of the overall tax system and mobilize additional revenues critical to finance countercyclical spending. This would entail (a) reducing tax expenditures and broadening the tax base and (b) strengthening tax administration and enforcement mechanisms to minimize tax evasion.
- **Improving the quality and efficiency of public expenditures**, especially in procurement and the wage bill; targeted transfers will be essential to gain spending efficiency and support planned convergence to the FRL targets. Consequently, it will be critical to rationalize and increase the efficacy of social public spending by enhancing the pro-poor features of targeting mechanisms to boost and sustain the economic opportunities available to a largely poor and vulnerable population. This would entail significantly redressing the imbalance between recurrent spending, especially the wage bill, and capital expenditure.
Prioritizing capital spending that would have a positive effect on capital accumulation and economic growth and could attract private investments in key economic sectors. Such expenditure could aim at climate adaptation and mitigation, helping the country cushion the impacts of frequent natural hazards. More resources could be made available by continuing and accelerating the pre-2019 trend away from current spending toward capital spending.

Transitioning to a more countercyclical fiscal policy would dampen business cycles, protect public investment, accumulate reserves of assets to respond to external shocks and better support long-term growth support. Dedicating budget resources to investment in disaster resilience and response to shocks ex ante will enable Honduras to conduct a more countercyclical fiscal policy.

Increasing domestic private and public saving and investment would help reduce Honduras’s dependency on external factors of growth, improve economic resilience against external and domestic shocks, make households and firms more secure and climate-resilient, and strengthen long-term economic growth.

Strengthening fiscal transparency by tracking, monitoring, and publishing more granular data on revenues and expenditures. This would allow for more concrete analysis of and recommendations on expenditure and revenue policies.

This PER considers two broad fiscal challenges faced by policy makers to strengthen fiscal resilience. Chapter 2 analyzes explicit and implicit contingent liabilities in the public sector, particularly in ENEE and BANADESA, that pose key fiscal risks in Honduras. The chapter also analyzes exposure, damages, and contingent liabilities caused by climate-induced natural hazards given Honduras’s high exposure and vulnerability to climate shocks. Further, the chapter discusses how to strengthen fiscal risk management to strengthen the preparedness to shocks and support sustainable recovery post natural disaster. Chapter 3 raises the issue of efficiency and performance of public spending in relation to the central government’s wage-setting framework. The chapter compares Honduras compensation levels with international peers, analyzes the drivers of the high wage bill, and examines the complex and ineffective legal and institutional framework governing the public sector wage bill. It necessitates a thorough revision of the compensation structure to improve transparency, fairness, and incentives in the public sector, thus leading to improved public sector performance.
Notes

1. The growth elasticity of Honduras with respect to growth in the G-7 economies, the most important external partners of Honduras, is 1.05, which is among the largest in the Latin American and the Caribbean (LAC) region (the region’s average is 0.67). Honduras is also one of the least internationally integrated country in the world. The United States alone absorbs more than 40 percent of Honduras’s goods exports and is a key source of investment and remittances.

2. See Marco Antonio Hernandez Ore, Liliana D. Sousa, and J. Humberto Lopez, Honduras, Unlocking Economic Potential for Greater Opportunities (Washington, DC, World Bank, 2015); and World Bank, Honduras: Paths toward Building a Resilient Society: Systematic Country Diagnostic (Washington, DC, World Bank, 2022). Honduras was the second country in the world most severely affected by extreme weather between 1997 and 2016 according to Sönke Kreft, David Eckstein, and Inga Melchior, “Global Climate Risk Index 2017” (Germanwatch briefing paper, Germanwatch e.V., Bonn, 2017). Moreover, the European Commission’s 2020 INFORM Index also identifies Honduras as the second-highest country at risk of disasters caused by natural hazards, especially those related to climate, epidemiological events, and conflicts in the Central American region. See “Global Crisis Risk Index Report” (INFORM, Luxembourg, 2020).

3. Every extra US$100 spent by the government is associated with an increase in the current account deficit of US$14, when everything else is kept constant (Ore, Sousa, and Lopez, Honduras, Unlocking Economic Potential).

4. Most remittances go to nonpoor households for their consumption. Policies could incentivize more productive use of remittances—such as investment and reconstruction that can be a powerful driving force for development and poverty reduction. World Bank, Honduras: Paths Toward Building a Resilient Society.

5. The 2.3 percent of GDP between 1980 and 2020 is an average annual loss from droughts, hurricanes, and flooding. The most significant event was Hurricane Mitch in 1998, which killed 14,600 people and inflicted economic losses of about 60 percent of GDP. See EM-DAT, the International Disaster Database, Centre for Research on Epidemiology of Disasters, Brussels, Belgium, www.emdat.be.

6. Climate change is expected to increase mean temperatures; intensify bad weather causing floods, heat waves, and droughts; and increase sea-level rise. See World Bank, Honduras Country Climate and Development Report (Washington, DC: World Bank, forthcoming, 2022).


8. The efforts to build disaster risk and fiscal risk management have been recent: the government prepared and adopted the Disaster Risk Management Strategy in 2020, which is currently being implemented. The fiscal risk unit within the Ministry of Finance was created in 2015 and tasked with monitoring and reporting fiscal risks; however, fiscal risks monitoring is limited and not accounted for in the preparation of the medium-term budget planning. The unit does not quantify risks from natural hazards yet.


10. These percentages are based on the official poverty lines in 2019. Honduras updated its official poverty measurement methodology using international best practice. Note that the new methodology (and corresponding updated poverty lines) coincidentally results in a 2019 poverty rate that is similar to the 49.0 percent estimated under the international poverty line of $5.50 per day.

government securities, local markets provide limited opportunities for banks and investors. Insurance penetration is low. Leasing and factoring services are underdeveloped, and the financial technology is nascent. See World Bank, Honduras: Paths toward Building a Resilient Society: Systematic Country Diagnostic.

12. Maquilas are businesses that can assemble, manufacture, or process raw materials and export the finished product largely free of duty and tariffs. They are present throughout Latin America and have been particularly successful in Honduras in generating growth and creating employment. According to the annual survey by the Central Bank of Honduras, the Honduran maquila sector grew by 8.8 percent (year on year) in 2019, up from 8.2 percent in 2018, whereas the aggregate economy grew by only 2.7 percent. The maquila industry is not well integrated with the domestic economy owing to its preferential tax treatment and regulatory incentives, thus reinforcing economic fragmentation.


15. These figures are from survey data reported by the Honduran Council of Private Enterprise for 2020.

16. For the international benchmarking exercise of Honduras, three groups of countries are considered: regional peers represented by the Central American average (including the Dominican Republic), structural peers, and aspirational peers. See appendix B for details on the definition and selection of peer countries.


18. Public Finance Control, Tax Exemptions and Measures against Tax Evasion Law (Ley de Ordenamiento de las Finanzas Públicas, Control de las Exoneraciones y Medidas Antievasión), entered into force January 1, 2014, made a series of tax reforms to address the country’s fiscal deficit and rein in tax evasion. Among them, the legislation increased the VAT rate from 12 percent to 15 percent for goods and services in general, increased the VAT of alcoholic beverages and cigarettes from 15 percent to 18 percent, and the creation of 1.5 percent alternative minimum tax.


25. World Bank staff calculations based on data from SEFIN.

26. The FRL set an NFPS deficit target of 1.0 percent of GDP in 2019 (deficit targets for the 2016−18 transition period were separately specified), limited growth of central government spending to average GDP growth over the past 10 years plus the next year’s projected average inflation, and limited floating rate debt to 0.5 percent of GDP at the end of each fiscal year.


30. This procyclicality is driven by spending on goods and services, and social benefits. Wages (that is, compensation to employees) and interest payments do not show correlation with the business cycle.

31. Namely, during a boom: (a) government spending as a share of GDP should go down because of automatic stabilizers; (b) with constant tax rates and some degree of progressivity, government revenues as a share of GDP should go up, and (c) the budget surplus as a share of GDP should increase. The opposite should occur in recessions.

32. The associated impacts of the twin shocks of 2020 on households’ and firms’ income gave rise to new arrears of about 1 percent of GDP by the end of June 2021.

33. Note that the 10-year, US$600 million bond placement in June 2020 was almost entirely used to repay external PPG debt (US$500 million) of the state electricity company (ENEE).
34. The fiscal package includes above-the-line measures (spending on health and nonhealth sectors, and accelerated spending or deferred revenues), and liquidity support (equity injections, loans, and contingent liabilities). Other economies in Latin America and the Caribbean with a similar output decline are Argentina, Bolivia, Colombia, and Peru.

35. The baseline scenario does not account for climate-related shocks.

36. Honduras’s debt stabilizing primary balance (DSPB) is −0.2 percent of GDP, whereas the average of the projected primary balance for 2021–23 is −1.6 percent of GDP. Calculations based on real GDP growth and fiscal projections from World Bank Group’s Macro Poverty Outlook: Country-by-Country Analysis and Projects for the Developing World (Washington, DC: World Bank Group, 2022).
2. Fiscal Risks: Sources and Management

Honduras’s public finance has been highly vulnerable to the materialization of contingent liabilities, in part because of limited analysis and management practices, as well as a lack of fiscal buffers and operationalization of the disaster risk financing strategy. This resulted in the limited ability of the authorities to cope with cyclical downturns and natural hazards, undermining macroeconomic stability and long-term growth. The COVID-19 pandemic and Hurricanes Eta and Iota in 2020 underscored the macroeconomic significance of fiscal risks from various sources. A key source of fiscal risk in Honduras is the contingent liabilities in the public sector, particularly the energy state-owned enterprise (ENEE) and one state bank (BANADESA). Disasters caused by natural hazards are another significant and frequent source of fiscal risks, causing annual losses of about 1.8 percent of gross domestic product. This chapter analyzes these types of fiscal risks in Honduras, evaluates the quality of risk analysis, and provides practical recommendations to strengthen their management.
2.1 Explicit and implicit contingent liabilities

Honduras’s public finances are exposed to a variety of fiscal risks; however, fiscal risk analysis is still in its early stages. Sources of risks include various shocks to macroeconomic variables (economic growth, commodity prices, and interest rates) and explicit and implicit contingent liabilities. The main sources of contingent liability risks include the subset of debt-related fiscal risks stemming mainly from the public sector, such as risks from the borrowing of subnational governments, state-owned enterprises (SOEs), litigations, and public-private partnership (PPP) plans. Other significant risks arise in the management of trust assets and liabilities and natural hazards.1 However, most aggregate contingent liabilities are not fully analyzed or disclosed yet.2 Honduras institutionalized the evaluation of fiscal risks along with the adoption of the fiscal responsibility law (FRL) in 2016. (See box 2.1.)

Honduras’s 2021 fiscal risk statement (FRS)3 highlights the Honduran public sector’s extensive exposure to explicit and implicit contingent liability (CL) risks. Explicit and implicit direct contingent liabilities roughly range between 35 percent and 70 percent of gross domestic product (GDP), depending on the severity of the assumptions (table 2.1).4 More specifically, explicit CL risks fluctuate between 30.9 percent and 54.7 percent of GDP. The largest sources of risks emerge from loan guarantees, including those embedded in energy creation contracts, and legal disputes against the central government. Implicit CL risks are relatively lower and fluctuate between 3.7 percent and 14.7 percent of GDP. The largest implicit CL risks derive from the nonfinancial SOE sector, which ranges between 2.2 percent and 11.2 percent of GDP. Furthermore, the FRS identifies other sources of risks, such as guarantees extended to PPPs and debts contracted by municipalities and trust funds, however, their materialization would have a milder impact on the budget.

Loan guarantees, extended mainly to the energy sector, pose a key fiscal risk. The guarantee portfolio amounts to at least 18 percent of GDP, and ENEE is the beneficiary of more than 90

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Box 2.1. Fiscal Risks

Fiscal risks are the possibility of deviations of fiscal outcomes from the expected fiscal outcomes at the time of budget formulation. This deviation might create significant impacts on government finances and impair the capacity of governments to use fiscal policy to stabilize economic activity and support long-term growth.

Sources of fiscal risks may be explicit or implicit, direct or contingent (appendix G). On the one hand, explicit liabilities pose a legal obligation to the government. Implicit liabilities, on the other hand, are based on expectations about government behavior. Whereas the government has no legal obligation to incur implicit liabilities, there may be a strong moral or political impetus to do so. Direct liabilities are predictable obligations that arise in any event, whereas contingent or indirect liabilities are obligations triggered by a discrete—but uncertain—event.
percent of outstanding guarantees (figure 2.1). The majority of guarantees are issued for ENEE’s domestic borrowing, of which nearly two-thirds were issued in 2019 and 2020. The remaining outstanding government guarantees have been issued for external borrowing from the development bank (BANHPROVI), the National Ports Company (ENP), the Aguán Farmworkers Unification Movement, and the National Autonomous University of Honduras. Explicit exposure to PPPs is lower, as is exposure to implicit liabilities. The country’s significant exposure to credit risk from loan guarantees, especially from ENEE, highlights the need for appropriate risk mitigation tools and a more in-depth analysis of the energy sector in the FRS.

**Substantial risks stem from energy generation contracts, with a support agreement from the National Congress.** The 2020 FRS risk analysis incorporates 70 energy generation contracts amounting to 19.5 percent of GDP. Whereas these contracts do not carry an explicit legal guarantee from the central government, the National Congress has approved a support agreement, thereby transforming the contracts into explicit contingent liabilities.

**Central government on-lending concentrates in ENEE and two other SOEs (figure 2.2).** Outstanding on-lent loans amount to roughly 6.6 percent of GDP at the end of 2020. More than 90 percent of it has been channeled to ENEE, and the remaining 10 percent to the financial SOEs, Public Agricultural Development Bank (BANADESA) and BANHPROVI. Only two loans were on-lent to ENEE after 2017. However, they were large relative to previous operations, and they reflect nearly half of the debt outstanding of on-lent funds. Some ambiguity remains around the quality of the data on on-lending and loan guarantees, as numbers for both differ across different databases.
The budgetary cost of PPP contracts is significant. In 2020, the government paid a total of US$175 million (0.7 percent of GDP) on PPP contract-related contingent liabilities arising from direct fiscal commitments (US$160 million) and contingent liabilities (US$15 million). In 2021, fiscal commitments are expected to exceed those of 2020 by about US$60 million (add 0.2 percent of GDP). Moreover, some of the contracts were denominated in US dollars, thereby transferring the foreign exchange risk to the public sector. Given the importance of private investment to close the existing infrastructure gap, more PPP projects should be expected if the ceiling is revised upward. According to the fiscal risk unit (FRU), five additional PPPs are currently in the structuring phase, even though the PPP-related budgetary limit has been currently reached.

Fiscal risks in the energy sector

The energy sector is a major hindrance to Honduras’s development because of its high costs, limited access, and low reliability. Whereas the electricity access level in Honduras is relatively high, with rural access lagging somewhat behind (at 82.9 percent in 2021), electricity service is unreliable. Power shortages are common, with daily blackouts in some regions. Indicators of quality of service and operational performance are among the worst in the region. ENEE’s combined technical and nontechnical distribution losses were estimated at 36 percent in 2017 and remain elevated at 33.4 percent in 2021 (versus 8 percent for best industry practice)—the highest level in Central America. In the 2019 Global Competitiveness Index, Honduras ranked 110th out of 141 countries in electricity access and 103rd in electricity service quality.

The mismanagement of ENEE is at the root of the energy sector challenges that deteriorated the company’s financial situation. ENEE’s persistent deficit stems from a combination of
structural weaknesses and high commercial losses in the inefficient distribution and transmission systems, expensive and limited generation capacity, and misaligned tariffs, as well as weak institutional and governance framework. These factors have exacerbated structural challenges related to the financial sustainability of the electricity company. The deficit of ENEE, which represents the key challenge for meeting the nonfinancial public sector (NFPS) deficit ceiling, rose markedly in 2018 as distribution losses remained high, investment in infrastructure remains insufficient, and higher oil prices raised production costs in the run-up to COVID-19 crisis. The sector’s dysfunctions pushed the debt stock of ENEE up to about US$2.9 billion in 2019 (about 11.6 percent of GDP), compared with US$1.9 billion (9.0 percent of GDP) in 2016 (figure 2.3).

**Significant direct and contingent liabilities of ENEE pose fiscal risks to the government.** Current liabilities of and to ENEE represent a large part of the government’s direct explicit liabilities. These include debt government has procured and on-lent to ENEE, ENEE’s payables in relation to independent power producers (IPPs) and Empresa Energía Honduras (EEH), and ENEE’s receivables from the sale of electricity. The materialization of fiscal risks from other current liabilities of ENEE is contingent; for example, on ENEE’s ability to repay guaranteed debt and court decisions in the case of legal proceedings against ENEE. In addition to current liabilities, government finances may be affected by the accumulation of future liabilities. Future liabilities of ENEE arise from existing and future contractual obligations (for example, with EEH, independent power producers, and employees), legal proceedings against ENEE, policy decisions (such as restructuring the electricity sector), and exogeneous events such as natural hazards. ENEE’s ability to honor its obligations depends on ENEE’s operational performance and ability to reduce technical and nontechnical losses, exogeneous factors such as oil prices and rainfall, and the size of recurring government subsidies.

**Figure 2.3. ENEE’s Fiscal Position, Percentage of GDP**

![Figure 2.3. ENEE’s Fiscal Position, Percentage of GDP](image)

*Source: World Bank Group staff estimations based on data from Banco Central de Honduras, the Ministry of Finance, and the International Monetary Fund.*
Honduras's fiscal hedges from the electricity sector are limited. Fiscal hedges include the repayment of on-lent loans by ENEE, tax revenues and customs duties from the electricity sector, potential reserve funds and insurance, and more indirectly tax revenues from wider economic activity enabled by the supply of electricity. In addition to currently identifiable risks captured in the fiscal risk matrix, new risks may emerge. As the electricity sector evolves, new business operations may create new risks for the government. Those new risks, for example, could include new borrowing in the future, new independent power producers entering into power purchase agreements with ENEE, and new lawsuits brought against electricity sector companies. The buildup of future liabilities will partially be defined by the government’s ability to sustainably reform the sector.

The fiscal risk matrix (table 2.2) illustrates key sources of liabilities and arrears in the electricity sector in Honduras. As of mid-2019, the estimated stock of total direct and contingent liabilities stood at about US$3,095 million (12.3 percentage of GDP), whereas further fiscal pressures from energy sector contingent liabilities are expected to continue. Fiscal risks owing to uncertainties in the cost of power to be purchased from IPPs each year, frequent droughts, interest rates, and oil price volatility are leading to a buildup of the government’s contingent liabilities. This situation is exacerbated by the fact that energy tariff adjustments in Honduras have not kept pace with international oil prices. Since ENEE is unable to generate sufficient cash to continue honoring its obligations, reprofiling ENEE’s liabilities will be important to reestablish liquidity. For example, ENEE’s obligations include payments for electricity purchased and debt service payments. However, mitigating a liquidity crisis at ENEE alone will not solve underlying challenges in the sector.

The impacts of the COVID-19 pandemic and Hurricanes Eta and Iota further weakened the financial position of ENEE. Total electricity demand in Honduras declined by 6.7 percent between March and June 2020 owing to the COVID-19 lockdown measures. Furthermore, the demand did not fully return to pre-COVID-19 levels until October 2020, which decreased ENEE’s revenues by 15 percent in 2020 compared with the previous year. As part of mitigation measures, the government prohibited ENEE to suspend household electricity services during the crisis and allowed deferred payments. This action contributed to increasing ENEE’s accounts receivables and jeopardized the company’s ability to pay for private power generators. In addition, the two hurricanes led to a reduction in electricity demand of 19 percent from October to November 2020 (a 4.5 percentage drop compared with 2019), causing partial blackouts that affected about 2.6 million people, mainly in the Valle de Sula, Atlantic Coast, Yoro, and Francisco Morazán areas. The effect of these crises can be seen in ENEE’s operating income, which decreased by nearly 15 percent in 2020, compared with 2019. Distribution and transmission losses, which totaled 31.8 percent as of early 2022, continue undermining the financial position of ENEE. As a result, the debt stock of ENEE increased to about US$3.7 billion in 2021 (about 14 percent of GDP), whereas the deficit remained elevated at 1 percent of GDP.

The continued deterioration of ENEE’s financial position further increases fiscal risks. The economic impact of the pandemic and hurricanes on households led to delays in the payment of
### Table 2.2. Fiscal Risk Matrix for the Electricity Sector in Honduras (Estimates as of Mid-2019)

<table>
<thead>
<tr>
<th>Direct liabilities</th>
<th>Contingent liabilities</th>
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<tr>
<td><strong>Source of risk</strong></td>
<td><strong>Cost/risk estimate</strong></td>
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<tr>
<td>Explicit liabilities</td>
<td>Government debt on-lent to ENEE</td>
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<tr>
<td></td>
<td>EEH’s receivables from service contract with ENEE</td>
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<td></td>
<td>Payables of private and public sector entities to ENEE</td>
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<td>Payables from ENEE to independent power producers</td>
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<td></td>
<td>Government guaranteed debt of ENEE</td>
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<tr>
<td>Implicit liabilities</td>
<td>Recurring support from government to ENEE</td>
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Note: — = not available; DRM = disaster risk management; EEH = Empresa Energía Honduras; ENEE = Empresa Nacional de Energía Eléctrica (National Electric Power Company); FX = foreign exchange; IPPs = independent power producers.

a. As of December 31, 2018.
electricity bills, exacerbating the liquidity pressures on ENEE and resulting in ENEE owing more arrears to electricity generators. Together with its additional total liabilities, ENEE currently faces two additional contingent risks that might increase debt further. First, the combination of consumers’ arrears and measures deployed during the pandemic led to an increase in receivable accounts by 43 percent year over year during 2020 and 28 percent during 2021, as the government prohibited the suspension of the electricity service during the crisis, including in the event of nonpayment. Whereas accounts payable represented on average 21 percent of ENEE’s total assets between 2016 and 2019, they increased to 29 percent in 2020. Second, the government’s ongoing conflict with EEH, the company subcontracted to manage the distribution network and to reduce losses, claims around US$673 million to ENEE. If the arbitration finds against ENEE, EEH may receive a significant portion of the total amount claimed. When two contingencies are considered, total liabilities and contingencies account for nearly 20 percent of GDP. This scenario puts at risk not only the provision and quality of services but also the national finances.

The limited funds available for ENEE to remediate the damages incurred owing to the hurricanes called for additional government support to the sector and consumers. To help ease liquidity pressures in the sector, in 2020, the government allocated US$500 million to pay off historical ENEE arrears to electricity generators, as well as the debts held by the ENEE trust funds. To achieve this, Honduras placed a US$600 million sovereign bond at 10-year maturity and 5.6 percent interest rate in June 2020. The authorities also placed ENEE on the pseudo-bankruptcy regime that applies to public entities in 2020. In the 2021 budget, the authorities have guaranteed to pay the electricity bills of public institutions. Furthermore, in 2020, the government provided...
a subsidy for 1.3 million households that consumed up to 300 kilowatt-hours (kWh) per month, accounting for about US$21 million (0.1 percent of GDP). In February 2022, Honduras exempted residential consumers with a monthly consumption below 150 kWh from paying for electricity. In addition, the government announced in March 2022, that it will absorb 50 percent of the increase in fuel prices amid the conflict in Ukraine.

Despite various legal and regulatory reforms enacted over the past decade, little progress has been made with regard to improving ENEE’s financial situation. On May 11, 2022, Congress passed a new energy law—Ley Especial para garantizar la energía eléctrica como un Bien Público de Seguridad Nacional—to lay the groundwork toward a reform of the sector. However, it is expected that additional measures will be necessary to address some of the root causes of the poor sector performance. These additional measures should also include a dialogue about independent system operators (ODS), the regulatory commission (CREE), and power purchase agreements.

Deep and broad governance, structural, and institutional reforms are urgently needed to prevent ENEE from further accumulating liabilities. This objective begins with key short-term priority measures: (a) preparing a credible loss-reduction program to reduce transmission and distribution losses, and taking adequate measures for its early implementation; (b) improving governance and efficiency in power theft detection and mitigation; (c) implementing the tariff regulations based on an updated cost-of-service study to reach full cost recovery; (d) preparing network investment plans; and (e) adopting a program with a deadline to eliminate arrears from public sector consumers. Further, improvements in infrastructure remain pertinent, as quality and affordable electricity service are critical for households and firms. Special attention should be directed to the current subsidy structure, which is both fiscally costly and highly untargeted. Improving the financing strategy of ENEE to reduce risk concentration and renegotiating contracts with producers will also help improve quality and affordability. Additional efforts are required to fully implement the regulatory framework and strengthen the overall institutional framework. These efforts are at the core of strengthening the electricity sector and protecting fiscal sustainability. Moreover, the reforms in the electricity sector can potentially yield important fiscal savings that have not yet been incorporated into the macro-fiscal framework.

Stress test of the banking sector
Honduran banks entered the COVID-19 crisis with a limited capital cushion. In 2019, the banking system had a capital adequacy ratio (CAR) of 13.7 percent, which lagged peers in Central America, Panama, and the Dominican Republic (CAPARD) at 17.0 percent and Latin America at 16.6 percent. Most larger banks exhibited lower than the systemwide CAR (averaging 13.2 percent, compared with 16.5 percent in smaller institutions). Portfolio quality was sound, with the nonperforming loan (NPL) ratio at 2.2 percent, in line with CAPARD (2.2 percent) and Latin America and the Caribbean (2.7 percent). Only one of the largest Honduran banks showed a relatively high ratio of 5.4 percent. The ratio of provisions to NPLs stood at 135.0 percent, with all the institutions showing no underlying issues (box 2.2).
Box 2.2. Current Fiscal Risks of State-Owned Banks

**BANADESA:** This agricultural development bank presents mostly a materialized fiscal contingency, as it has a full government guarantee that could exceed 1.0 percent of gross domestic product (GDP). It has faced a steep deterioration of its portfolio to the point that the institution no longer appears to be viable, with a nonperforming loan (NPL) ratio that reached 68.0 percent in 2017. The government of Honduras has worked on different resolution alternatives for BANADESA, some of which entail the materialization of contingent liabilities. A pending proposal to close BANADESA awaits Congress’s approval. A final determination on BANADESA has yet been made.

**BANHPROVI:** The development bank with a strong balance sheet, however, with direct contingent liabilities amounting up to 1.3 percent of GDP. Whereas BANHPROVI’s balance sheet is strong, the expansion of its tier 1 lending operations to fill those unserved by the discontinuation of operations by BANADESA could present new risks in the medium term. NPLs in tier 2 portfolio represented only 1.7 percent of gross loans in 2021, compared with an average of 3.1 percent of commercial banks. The quality of the tier 1 portfolio is poorer: the NPL ratio stood at 6.5 percent in 2020. Moreover, BANHPROVI is directly exposed to a sudden depreciation of the lempira. Its short foreign currency position was noncompliant with the National Commission on Banking and Insurance requirements at 19.1 percent of capital in 2021. In addition, BANHPROVI has implemented a number of the government’s measures to support micro, small, and medium enterprises through the COVID-19 crisis. These measures included the establishment of three new partial credit guarantee funds, which could pose direct contingent liabilities of up to 2.4 percent of GDP in case the target leverage of the Reactivation of Micro, Small and Medium Enterprises (MIPYME) Guarantee Fund was reached. However, the bank’s use of public capital injections as the main source of funding implies a substantial capital cushion, with a capital adequacy ratio a 129 percent of risk weighted assets in 2021, hence no contingent liability risk is anticipated. Currently, BANHPROVI’s financial statements do not comply with international standards, in contrast with other commercial banks in Honduras.

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a. BANADESA presented significant administrative and financial deficiencies, including irregularities described by the National Anti-Corruption Board (CNA). Moreover, BANADESA faced elevated levels of NPLs that were partly explained by the moral hazard fostered by six rounds of debt forgiveness to BANADESA borrowers decreed by Congress between 1992 and 2008.

b. BANHPROVI’s total liabilities are equivalent to 0.7 percent of GDP. The institution has signed a US$225 million loan agreement with BCIE (Banco Centroamericano de Integracion Economica), of which US$75 million has been disbursed. If the entire loan was disbursed, the total liabilities of the institution would total 1.3 percent of GDP.

c. The three new partial credit guarantee funds are (a) the Guarantee Fund MIPYMES, with L 2,500 million in capital; (b) the Larger Firms Guarantee Fund (EMT) with L 1,900 million in capital; and (c) the Agrocrédito program with L 525 million. As a trustee of the MIPYMES Guarantee Fund, BANHPROVI has signed guarantee agreements with 29 financial intermediaries, including banks, financial companies, and credit unions. EMT has a similar structure to MIPYMES, involving nine commercial banks and a financial company and a maximum guarantee of L 50 million (US$2.1 million). Agrocrédito is a comprehensive program that includes elements of subsidized credit, guarantee, and technical assistance to improve financial inclusion of agricultural producers. The guarantees granted by Agrocrédito will only be provided to foster the participation of financial intermediaries in the lending program, which caps their financial margin to 5.7 percent.

d. Based on official projections for MIPYME Guarantee Fund (L 19,000 in loans with a 90 percent guarantee, minus the capital of the fund). Fiscal exposure will depend on the actual partial credit guarantees leverage. No projections are available for EMT and Agrocrédito.
Limited data from the pandemic period may mask underlying issues in the banking sector. As of November 2021, systemwide NPLs represented only 3.1 percent. The average CAR stood at 14.1 percent, with all banks meeting capital requirements. Provisioning increased significantly, representing 200 percent of NPLs. Nonetheless, the authorities’ response included a set of regulatory forbearance measures that allowed borrowers affected by COVID-19 and later by Hurricanes Eta and Iota to restructure and refinance their loans. The loans that underwent such processes could be considered to have a higher default risk than the rest of the portfolio, flagging an underlying vulnerability of the banking sector in the following quarters. As of June 2021, 28.7 percent of the loans outstanding in Honduras had gone through a COVID-19 or hurricane-related restructuring. Moreover, 6.1 percent of the system’s loans were refinanced under the regulator’s special terms.

A set of stress test exercises show that the financial sector may give rise to fiscal contingent liabilities in Honduras, as high as 1 percent of GDP. These liabilities include the obligations that appear from a financial crisis due to explicit (for example, deposit insurance) or implicit guarantees. The analysis conducted two sets of stress test exercises (see table 2.3). The first was intended to gauge the magnitude of banks’ capital shortfall under different scenarios, ranging from a small to a significant increase in NPLs, showing that the fiscal cost could go from negligible to as high as 1 percent of GDP. The second included a foreign exchange (FX) shock that severely affected unhedged borrowers (noncurrency generators; NGDs). The findings show milder fiscal costs, up to 0.3 percent of GDP, since most banks have long FX positions, whereas some unhedged corporate borrowers may have the means to shield their balance sheets.14

The National Commission on Banking and Insurance (CNBS) has been taking steps to increase capitalization levels in the local banks. In December 2020, the CNBS required banks to set a restricted nondistributable capital reserve. This reserve was set to be used to cover deterioration of the loan portfolio affected by the COVID-19 crisis and Hurricanes Eta and Iota, providing a small margin for banks to prevent recapitalization. As of December 2021, the systemwide restricted capital reserve account (which includes several restricted reserve items) represented 2.6 percent of the banks’ capital.

### Table 2.3. Possible Fiscal Contingent Liabilities Associated with the Financial Sector

<table>
<thead>
<tr>
<th>Scenario</th>
<th>L millions</th>
<th>Share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking system stress tests on three shock scenarios*</td>
<td>276–6,271</td>
<td>0.04–1.00</td>
</tr>
<tr>
<td>FX shock with and without partial hedge by NGDs</td>
<td>171–1,852</td>
<td>0.03–0.30</td>
</tr>
</tbody>
</table>

* Source: World Bank staff assessment using data from CNBS.

Note: FX = foreign exchange; GDP = gross domestic product; L = lempira; NGDs = noncurrency generators. The exercise is not intended to provide forecasts for nonperforming loans or assign probabilities to certain outcomes.

a. Scenario 1: Shock affects at least 20 percent of systemwide risk-weighted assets. Scenario 2: A severe shock based on 2020 GDP dynamics—the COVID-19 shock caused an unprecedented contraction in economic activity. Scenario 3: This is a worst-case scenario shock, along the lines of the Honduran experience of the banking sector after the country was hit by Hurricane Mitch in 1998.
2.2 Fiscal risks due to natural hazards

Honduras’s high exposure and vulnerability to extreme natural hazards\(^\text{15}\) threatens its economic stability and achievement of social development objectives (see figure 2.5). Natural hazards in Honduras have affected, on average, 4.5 percent of the population each year and caused more than 2.3 percent of GDP in damages.\(^\text{16}\) In particular, climate-induced natural hazards have generated significant delays in the economic and social development of the country. Floods are the most destructive events, followed by droughts, while other sectors are also affected, such as transportation, telecommunications, agriculture, health, education, water, and sanitation.

Figure 2.5. Hazard Mapping by Municipality

a. Drought

- Overall country hazard level: Medium
- Potentially damaging and life-threatening river floods are expected to occur at least once in the next 10 years

b. Flood

- Overall country hazard level: High
- Potentially damaging and life-threatening river floods are expected to occur at least once in the next 10 years

c. Hurricane

- Overall country hazard level: High
- There is more than a 20 percent chance of potentially damaging wind speeds in your project area in the next 10 years.
The dynamic impact of the seven largest hurricanes has been devastating for Honduras. They were associated with an immediate impact of 4.6 percentage points reduction in the growth rate, 16 percentage points reduction in investment, and 3.7 in private consumption. Some events have affected 4 percent of the population and caused damage exceeding 59 percent of GDP. The Global Climate Risk Index classified Honduras as the second most severely affected country in the world by extreme weather events in the period 1998–2017, highlighting the acute vulnerability to climate change and the country’s low preparation to respond. Climate change is expected to increase global mean temperatures; intensify weather events, such as floods, heatwaves, and droughts; and increase sea-level rise. Since Honduras’s disaster losses are mostly through excess rain (floods), tropical cyclones (windstorms), and droughts, they will likely increase in frequency and severity as a result of climate change.

The high vulnerability to natural hazards in Honduras exposes the country to significant contingent liabilities. Even in a no-climate-change scenario, disasters caused by natural hazards continue to weigh on Honduras macro-fiscal outlook. Based on historical growth and natural hazards risk patterns, the combined impact of destroyed productive capital through natural hazards would amount to cumulative losses of around 5.4 percent of GDP by 2050. Furthermore, the combination of lower growth rates, eroded fiscal space, and additional financing needs for reconstruction are expected to increase to public debt levels by about 6.2 percentage points of GDP by 2050. Contingent liabilities from disasters caused by natural hazards, including emergency and rehabilitation expenditures and reconstruction, are highly clustered around high-impact/low-probability events. For instance, with an annual probability of 1 percent, CLs from excess rain, strong winds, and earthquakes would amount to at least 8.5 percent of GDP (13.1 percent on average for the 1 percent worst outcomes) but rises to at least 16.1 percent (22 percent on average) in the worst 0.2 percent (1-in-500 years) of outcomes (see box 2.3). Severe data limitations did not allow assessment of the impacts and contingent liabilities of other natural hazards in key sectors, including agriculture.

Natural hazards can trigger instability in the banking sector, increasing the need for potential fiscal support. Given the structure of the Honduran financial sector—which is bank-based and focused on credit and lending to the Government of Honduras with little private equity and debt investments—it is likely that one of the most systemic impacts of climate-related risks would be through losses in banks’ credit portfolios (see box 2.4). Using the information of Hurricane Eta’s and Iota’s impacts on borrowers’ creditworthiness as a benchmark, 6.2 percent of all loans could become nonperforming, triggering a 3.3 percentage point drop in banks’ tier 1 capital ratio by 2050. Climate change could also increase the expected annual damage from river floods in Honduras by 13 percent by 2050. However, the risk to the banking sector from these stronger floods remains moderate. Moreover, longer and more frequent droughts are expected to affect agriculture production; however, the impacts to the banking sector’s credit quality are expected to be limited. Nevertheless, the government faced the materialization of this type of contingency in the past, in particular, in the aftermath of hurricane Mitch in 1998. The disruption of economic activity determined a surge in bad loans, with the systemwide NPL ratio peaking at 11.4 percent in 2001, pushing several banks into bankruptcy. The fiscal cost of the crisis was estimated at 5.0
Box 2.3. Damages and Contingent Liabilities due to Natural Hazards

The stochastic distribution of damages from natural hazards is estimated from outputs of full probabilistic catastrophe models for geological (earthquake; EQ) and hydrometeorological/climate (tropical cyclone; TC, and excess rainfall; XsR) hazards. Estimations are based on the average value of destroyed capital from natural hazards from the exceedance curves (ECs) provided by the Caribbean Catastrophe Risk Insurance Facility (CCRIF) SPHERA (earthquake and tropical cycles) and XsR2.5 (excess rain) models. No robust loss models are available to estimate probabilistically future losses in Honduras for other important climate change–related risks, such as excess heat, drought, landslides, and wildfires. The EQ model does not include damage by tsunamis, while the TC model quantifies damages from wind and storm surge. The CCRIF’s SPHERA (EQ and TC) and XsR2.5 (XsR) models are used to assess national reconstruction losses and the CLs are assumed to be a percentage of them. Losses are reported in relation to a stochastic distribution of nationwide damages to both public and private infrastructure, which have been updated to 2020 with an adjustment of the exposure based on growth in gross domestic product (GDP). Average combined losses are 2.3 percent of GDP in damages to infrastructure in a given year, and excess rain accounts for the most significant losses in the median year at 1.4 percent of GDP. However, damages from tropical cyclones dominate the downside risk, with losses exceeding 13.7 percent of GDP for 100-year return period events and 27.1 percent of GDP for 500-year return period events (see table B2.3.1).

Table 2.3.1. Risk Assessment of Contingent Liabilities (percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>EQ</th>
<th>TC</th>
<th>XsR</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.2%</td>
<td>0.4%</td>
<td>1.7%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Median</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.4%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Every 10 years</td>
<td>0.2%</td>
<td>0.3%</td>
<td>3.5%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Every 100 years</td>
<td>4.7%</td>
<td>13.7%</td>
<td>6.3%</td>
<td>16.2%</td>
</tr>
<tr>
<td>Every 500 years</td>
<td>12.3%</td>
<td>27.1%</td>
<td>8.2%</td>
<td>29.0%</td>
</tr>
</tbody>
</table>

Note: Return period (or recurrence interval or repeat interval) is an average time between natural hazard events.

Not all reconstruction costs are borne by the government. Contingent liabilities due to natural hazards arise from (a) emergency and rehabilitation expenditures (E&R), which based on historical data are estimated at 15 percent of total reconstruction costs; (b) reconstruction of public assets and infrastructure, which based on available information on sector distribution and ownership accounts for approximately 23 percent of total reconstruction costs; and (c) indirect contingent liabilities for potential support to vulnerable populations to rebuild damages to their dwellings. The timing of resource requirements depends on the nature of the contingent liability: whereas emergency and rehabilitation requires short-term liquidity to quickly respond in the aftermath of a natural disaster, the reconstruction may take months or even years to be executed.

Although this is a government decision, demands for such payments are politically difficult to resist in the aftermath of a disaster. Damages to residential real estate are
percent of GDP. Further strengthening the climate-related supervisory and regulatory toolkit is important to enhance the financial sector’s resilience in the face of physical and transition risks.

**Because of Honduras’s high vulnerability to natural hazards, disaster risk management (DRM) is one of the key aspects of climate change adaptation and fiscal resilience.** In December 2020, the authorities approved the Strategy for Disaster Risk Finance Management (SDRFM) and have started to implement its operations plan (August 2021). The strategy proposes a framework for setting a financing strategy to respond to postdisaster needs, segmented by the type of instrument and the time line of funding needs (see figure 2.6). The operations

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**Table 2.3.2. Risk Assessment of Contingent Liabilities: Total and Split among Phases (USD million and % of GDP).**

<table>
<thead>
<tr>
<th>Metric</th>
<th>Total</th>
<th>Emergency</th>
<th>Reconstruction</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAL</td>
<td>290.6 (1.23%)</td>
<td>83.6 (0.35%)</td>
<td>207.1 (0.87%)</td>
</tr>
<tr>
<td>VaR$_{1%}$</td>
<td>2,018 (8.5%)</td>
<td>581 (2.5%)</td>
<td>1,438 (6.1%)</td>
</tr>
<tr>
<td>VaR$_{0.2%}$</td>
<td>3,818 (16.1%)</td>
<td>1,098 (4.6%)</td>
<td>2,720 (11.5%)</td>
</tr>
<tr>
<td>TVaR$_{1%}$</td>
<td>3,108 (13.1%)</td>
<td>894 (3.8%)</td>
<td>2,214 (9.4%)</td>
</tr>
<tr>
<td>TVaR$_{0.2%}$</td>
<td>5,209 (22%)</td>
<td>1,498 (6.3%)</td>
<td>3,711 (15.7%)</td>
</tr>
</tbody>
</table>


Note: The risk assessments of total CL, disaggregated by postdisaster phases, use the following risk metrics: average annual loss (AAL), value at risk (VaR), and tail value at risk (TVaR). $\alpha$ is the annual exceedance probability linked to the metrics. The assumptions, in particular, the percentage of CLs to national reconstruction losses, to be confirmed with the Government of Honduras.
Box 2.4. Exposure of the Honduran Banking Sector to Natural Hazards

The Honduran banking sector is strongly exposed to physical risks stemming from hurricanes with lower exposure to flood and drought risks. Banks’ exposure to physical risks is determined by the spatial and sectoral composition of assets (table 2.4.1). Value-at-risk estimates show that 20.8 percent of the credit portfolio of banks in Honduras has high exposure to hurricanes, with the departments of Cortés and Francisco Morazán concentrating two-thirds of the portfolio at risk. The overall exposure to hurricanes in Honduras is in line with those of other countries affected by the Atlantic hurricane season. For Honduran banks, riverine floods present the second-largest climate-related risk as 9.2 percent of their credit portfolio is highly exposed to flood risk, which sits at the lower end of the distribution when compared across Latin American and the Caribbean. The banking sector is less exposed to droughts as only a minor fraction of the portfolio has drought risk due to the relatively low exposure of Honduran banks to the agriculture sector (7.5 percent of total credit portfolio).

Table 2.4.1. Share of Bank Credit Portfolio to NFCs Potentially Exposed to Selected Physical Risks

<table>
<thead>
<tr>
<th>Department</th>
<th>Droughts</th>
<th></th>
<th>Floods</th>
<th></th>
<th></th>
<th></th>
<th>Hurricanes</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Med</td>
<td>Very Low</td>
<td>Low</td>
<td>Med</td>
<td>High</td>
<td>Low</td>
<td>Med</td>
<td>High</td>
</tr>
<tr>
<td>Cortés</td>
<td>2.00</td>
<td>0.01</td>
<td>0.00</td>
<td>0.04</td>
<td>0.13</td>
<td>7.01</td>
<td>7.20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Francisco Morazán</td>
<td>0.99</td>
<td>0.00</td>
<td>6.69</td>
<td>0.01</td>
<td>0.01</td>
<td>0.00</td>
<td>6.71</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Choluteca</td>
<td>0.60</td>
<td>0.00</td>
<td>0.12</td>
<td>0.01</td>
<td>0.00</td>
<td>0.72</td>
<td>0.84</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Copán</td>
<td>0.65</td>
<td>0.04</td>
<td>0.32</td>
<td>0.20</td>
<td>0.49</td>
<td>0.01</td>
<td>1.01</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yoro</td>
<td>0.75</td>
<td>0.00</td>
<td>0.07</td>
<td>0.03</td>
<td>0.00</td>
<td>0.83</td>
<td>0.93</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Atlántida</td>
<td>0.28</td>
<td>0.00</td>
<td>0.00</td>
<td>0.43</td>
<td>0.03</td>
<td>0.21</td>
<td>0.69</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Santa Bárbara</td>
<td>0.12</td>
<td>0.04</td>
<td>0.10</td>
<td>0.04</td>
<td>0.06</td>
<td>0.06</td>
<td>0.28</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Olancho</td>
<td>0.39</td>
<td>0.00</td>
<td>0.11</td>
<td>0.22</td>
<td>0.20</td>
<td>0.01</td>
<td>0.54</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comayagua</td>
<td>0.26</td>
<td>0.00</td>
<td>0.22</td>
<td>0.26</td>
<td>0.00</td>
<td>0.00</td>
<td>0.48</td>
<td></td>
<td></td>
</tr>
<tr>
<td>El Paraiso</td>
<td>0.27</td>
<td>0.00</td>
<td>0.12</td>
<td>0.20</td>
<td>0.01</td>
<td>0.01</td>
<td>0.35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other departments</td>
<td>0.78</td>
<td>0.12</td>
<td>1.08</td>
<td>0.20</td>
<td>0.16</td>
<td>0.32</td>
<td>1.78</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All departments</td>
<td>7.07</td>
<td>0.21</td>
<td>8.81</td>
<td>1.64</td>
<td>1.10</td>
<td>9.19</td>
<td>20.81</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: World Bank’s staff estimates based on data from Comisión Nacional de Bancos y Seguros (CNBS) and ThinkHazard, thinkhazard.org.

Note: NFCs = nonfinancial counterparties. Physical risks are derived from natural hazards and climate change that cause economic costs and financial losses. The Atlantic hurricane season runs from June 1 to November 30, encompassing the North Atlantic Ocean, Caribbean Sea, and Gulf of Mexico.
The government has taken the following actions as part of the strategy implementation: (a) the development of a disaster risk–related contingent

plan prioritizes actions on the following strategic lines: (a) knowledge generation of disaster risk, (b) resource mobilization and financial protection with a combination of disaster risk financing instruments, (c) disaster risk reduction through resilient public investments, (d) public expenditure efficiency and transparency regarding DRM spending, and (e) capacity development of the Ministry of Finance to enhance disaster risk finance management. Thus, the implementation of the strategy would help promote climate resilience and emergency response, and would provide a fiscal buffer to mitigate the risk to fiscal stability in the event of future hazards.

The early implementation steps of the SDRFM focus on quantifying the fiscal exposure to disasters, promoting policies to integrate DRM in public investment, and the diversification of instruments to manage this exposure. The government has taken the following actions as part of the strategy implementation: (a) the development of a disaster risk–related contingent
liabilities assessment methodology, which will quantify the potential impact of hydrometeorological and other climate-related natural hazards on the macro-fiscal accounts and identify financial needs to address the disasters, and (b) the establishment of technical guidelines for including an analysis of disaster risk reduction and climate-change adaptation in public investments, aiming to harmonize and standardize the use of the current technical instruments. The government is currently strengthening the legal framework by creating technical risk management units in all relevant public entities in charge of issuing sector-specific DRM plans, including gender considerations in government response and recovery, and analyzing instruments to improve financial preparedness for future natural hazards.

**Honduras has already applied available financial and fiscal instruments to respond to adverse events.** During 2020, the Ministry of Finance activated diverse financial mechanisms and instruments to respond to COVID-19 and Hurricane Eta and Iota emergencies, such as (a) a contingent emergency response component, (b) a DRM development policy credit with a catastrophe deferred drawdown option (Cat DDO) of US$119 million, (c) an emergency response investment project financing of US$150 million, (d) credits, (e) placements of bonds, (f) international support, and (g) budget reallocation. Notably, the National Fund for Preparedness and Response did not play a predominant role in financing the response. Currently, the Ministry of Finance is finalizing entrance into the Caribbean Catastrophe Risk Insurance Facility Segregated Portfolio Company (CCRIF SPC), a sovereign parametric insurance provider, with a planned policy for excess rainfall. The Ministry of Finance is also evaluating continent credits with the World Bank and Inter-American Development Bank. All these efforts are expected to increase fiscal resilience and the effectiveness of the National System of Risk Management. However, the challenge for Honduras is to move from a largely reactive policy—reallocating resources from within the budget for reconstruction after a disaster—to a more proactive fiscal strategy.

Despite recent efforts to increase fiscal resilience against disaster risk, Honduras faces challenges on financial management and risk reduction to minimize the impact of future events. Financing needs for disaster response, adaptation, and other urgent development priorities will likely exceed Honduras’s current fiscal capacity, and a comprehensive financing strategy is needed. The current SDRFM does not specify whether indicated financing instruments are readily available. Further, not all financing instruments are cost-efficient and for some expenditures in the immediate disaster aftermath, speed is of the essence, whereas others have a longer time horizon. Emergency relief expenditures require immediate liquidity, whereas the recovery might take months, and reconstruction can take even years. A layered financing approach involving risk retention and risk transfer instruments to finance short-term needs from natural hazards of various frequency and severity is advisable.

**Policy measures increase the disaster risk resilience, but come with important fiscal trade-offs that can be alleviated by a more proactive macro-fiscal policy approach.** Within a given budget envelope, measures such as accelerated reconstruction and adaptation investment can be effective in reducing the risk from natural hazards but do so at the expense of diverting resources away from other important development priorities. Some of these short-term trade-offs can be
relieved through a more proactive fiscal policy (versus reactive policy with reallocations within the budget in response to a disaster). A more proactive fiscal policy can dedicate additional resources to disaster risk management and combine a layered disaster risk financing strategy with budgetary provisions for adaptation investment. These proactive strategies need to include fiscal provisions to quickly finance additional expenditures for reconstruction and relief to affected populations after a disaster. This approach requires fiscal space, which could be created through additional revenue. In the short term, some additional debt financing might be justifiable to the extent that adaptation investment reduces economic volatility and thus increases the country’s ability to carry debt in a sustainable manner. Fiscal buffers and reforms that reduce the exposure of public budgets to climate shocks should be explored, as well as regulations and incentives for private sector investments in resilience. Reductions in disaster-induced volatility would positively affect debt sustainability and could thus unlock additional fiscal space.

**Policy actions to strengthen the resistance to natural hazards are subject to further analysis of the impacts of climate change, capacity constraints, policy impact analysis, and sustainability considerations.** Quantifying the climate investment and financing needs to address risks from climate shocks would enhance the assessment of the financial challenges and the long-term fiscal sustainability. It would also guide the intersectoral prioritization or resource allocation. A gap, opportunity cost, efficiency, and cost-benefit analysis in SDRFM could help evaluate alternative adaptation, disaster risk financing, and mitigation strategies to make more informed decisions about the available instruments. Further analysis should be carried out to assess potential losses and contingent liabilities arising from the key economic sectors.

### 2.3 Fiscal risk management

**Honduras has made substantial progress in monitoring fiscal risks, but risks are not proactively managed.** The government has created a fiscal risk unit and a framework for managing fiscal risks. According to the World Bank’s 2021 Assessment of Debt-Related Fiscal Risks in Honduras, the country’s 2021 FRS is well-developed and comprehensive, and complies with the legislation except in the case of risks from natural hazards. Furthermore, the recording and payment processes are well-defined. However, risk management remains limited to monitoring fiscal risks instead of managing the country’s exposure within a more comprehensive perspective. The FRU’s global risk analysis is not considered in the medium-term macro-fiscal framework, the implementation of fiscal rules, or the selection of the borrowing limits. Also, the FRS contains no critical information on the country’s exposure to and management of risks specific to PPPs, the debt portfolio of NFPS entities, or the energy sector. Debt reporting is very detailed but published annually.

**The legal framework is not fully implemented, especially on loan guarantees, and lacks risk mitigation measures—with most clauses focusing on risk monitoring.** Despite the existence of procedures, fiscal risks monitoring is not fully effective due to weak data reporting, which affects data analysis and timely decision making. SOEs refrain from external audits due to the inability to write-off bad loans, which requires congressional approval. Fiscal risk management
would be better served if the government took a proactive approach based on risk mitigation tools and actionable strategies for managing risks posed by SOEs, loan guarantees, municipalities, and PPPs. For example, ENEE obtained guarantees without fully abiding by the regulations. The legal framework lacks any requirements to analyze alternative financing options to ensure that loan guarantees are the most cost-effective option. Furthermore, whereas the legal framework sets out rules for managing loan guarantees, there are no on-lending objectives and risk management requirements in neither the 2004 Organic Budget Law (OBL) nor the FRL. Municipal fiscal transparency should be improved along with compliance with accounting processes and the transparency law.

**Different reports on fiscal risks are not linked to each other, or some reports are not concise and well-articulated, impeding readers from obtaining a synopsis of overall risks.** In addition to the FRS and its versions, several other documents include an in-depth analysis of specific risks. However, these reports are not well linked, impeding an easy overview and understanding of risks. Furthermore, some of the wording in the FRS might contribute to moral hazard. For example, projecting payments on nonguaranteed SOE debt, despite legislation stating that nonguaranteed debt of the NFPS should not be considered as an implicit guarantee, suggests that the government will stand behind all CLs and may create a moral hazard. Strategies in SDRFM for responding to postdisaster needs do not specify whether the proposed financing instruments are readily available. SOEs must fulfill the International Financial Reporting Standards (IFRS) and record all transactions in the SIAFI system by the end of each month. They must send to SEFIN the execution of the POA and financial statements on a quarterly and monthly basis, respectively.

**Recommendations on strengthening the management of fiscal risks.**

A more proactive fiscal risk management based on risk mitigation tools would be more beneficial rather than relying primarily on risk monitoring. Risk management strategies should include risk mitigation tools with a business continuity plan and budget appropriations to better inform fiscal policies. According to the 2021 Debt Management Performance Assessment (DeMPA) for Honduras, the business continuity plan should be updated and include guidelines for public debt operations. Debt reporting should also be updated at least every six months, with the debt coverage not being limited only to central government debt and aggregate figures. Furthermore, debt reporting should include fiscal arrears in the stock of overall central government debt and provide more details on the guarantees and on-lent portfolio. The FRS could be strengthened by including more details on risk exposure (including the energy sector), the followed methodology (including the conceptual framework of selected risk models), PPPs, and integrating it with other reports from the National Public Investment System of Honduras (Sistema Nacional de Inversión Pública de Honduras or SEFIN). To prepare for the materialization of risks, governments can charge guarantee fees, allocate budget resources, and put in place buffer funds. For example, in South Africa, Eskom, the state-owned electric utility is expected to hedge all foreign currency debt (guaranteed and non-guaranteed) by entering into cross-currency swaps.
Adherence to and expansion of the legal and institutional framework plays an important role in risk management. The legal framework currently does not include comprehensive risk mitigation tools and on-lending practices, while there are no objectives for loan guarantees. It is important to prevent any exemptions to normal procedures and all entities need to comply with the legal framework on guarantees. Modernization of the SOE legal framework is essential to improve data reporting on SOEs and to avoid fragmentation and inconsistencies. The fiscal transparency of the municipalities should comply with the accounting processes and the transparency law. Furthermore, the Integrated Municipal Administration System (SAMI) and the Integrated Financial Management System (SIAFI) could be linked together to allow SEFIN departments to better monitor CLs arising from each municipality. PPP risk management could be improved by fully implementing the current legal framework and strengthening the underlying analysis for selecting PPP projects. On the institutional framework, even though there is communication between different SEFIN units, collaboration and coordination could be strengthened.

Table 2.5 provides recommendations from the World Bank’s Assessment of Debt-Related Fiscal Risks in Honduras (2021) and the 2021 DeMPA. Recommendations on the overall fiscal risk management comprise the application of risk mitigation tools, a more effective presentation, and better integration of SEFIN reporting. Recommendations on risks from loan guarantees, SOEs, and other specific risks are narrower and aim at addressing shortcomings in the current legal and institutional framework on the respective risks. Recommendations on disaster risk management aim at mitigating the financing gaps cost effectively as well as output and welfare losses in the event of natural hazard–related shocks.

Specifically, to manage fiscal costs and risks from the electricity sector, further strengthening institutional arrangements is needed. Reform of the electricity sector need to be paired with reforms in fiscal policy making, specifically the identification, assessment, monitoring, and mitigation of fiscal risks, to protect fiscal sustainability. The proposed policy recommendations are as follows:

- Develop a clear and robust framework for valuing the fiscal risks associated with the different types of government support to the electricity sector. Such an assessment can build on the fiscal risk matrix (see section 2.1) and on the credit rating methodologies developed by the fiscal contingencies unit for port companies, water utilities, and the telecommunications sector. The credit rating methodology may be complemented by scenario analysis and stress testing (for example, for oil prices, rainfall levels, and so forth).
- Establish a fiscal risk committee that evaluates monitoring reports regularly and proposes policy measures to the government and ENEE.
- Establish fiscal commitment and contingent liability thresholds covering the extent of contribution of the public party in PPP transactions, in accordance with international sound practices.
Table 2.5. Recommendations to Improve Fiscal Risk Management

<table>
<thead>
<tr>
<th>Overall fiscal risk management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implement more proactive fiscal risk management, including risk mitigation tools and budget appropriations to better inform fiscal policies.</td>
</tr>
<tr>
<td>Include methodological notes in the FRS, describing the conceptual framework of selected risk models.</td>
</tr>
<tr>
<td>Strengthen the FRS with more details on the risk exposure and strategies to mitigate them by better linking and integrating different reports on fiscal risks.</td>
</tr>
<tr>
<td>Include a chapter dedicated to the energy sector in the FRS, applying a tailored risk assessment methodology for ENEE.</td>
</tr>
<tr>
<td>Debt reporting should include fiscal arrears in overall central government debt stock.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loan guarantees and on-lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adhere and expand the legal and institutional framework to include provisions for central government on-lending.</td>
</tr>
<tr>
<td>Enhance and implement the governance framework for loan guarantees and on-lending through clear policy objectives, alternative financing options analysis, and risk mitigation tools, including budget appropriations.</td>
</tr>
<tr>
<td>Improve coordination between the FRU and DGCP to enhance statistics and reporting.</td>
</tr>
<tr>
<td>Revisit the financing strategy for ENEE to reduce substantial risk concentration.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SOEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidate and modernize the SOE legal framework to avoid fragmentation and inconsistencies by improving SOE performance, including through performance contracts and SEFIN financial oversight.</td>
</tr>
<tr>
<td>Establish a coordination mechanism within SEFIN to strengthen analytics and decision-making, including a framework for detailed data collection on nonguaranteed debt, arrears, and floating debt.</td>
</tr>
<tr>
<td>An effective implementation of the 2014 ESL and the recently elaborated strategic plan to address the energy sector's vulnerabilities.</td>
</tr>
<tr>
<td>Develop an action plan to assist SOEs in completing external financial audits, for example through an SOE, SEFIN, and court of auditors working group.</td>
</tr>
<tr>
<td>Complement quarterly DGID reports with full-fledged annual SOE portfolio reports with more complete and transparent information.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other fiscal risks (municipalities, PPPs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhance municipal fiscal transparency and ensure full compliance with accounting standards, processes, and transparency law.</td>
</tr>
<tr>
<td>Enhance SEFIN coordination by integrating the municipal administration and financial management systems, SAMI and SIAFI.</td>
</tr>
<tr>
<td>Improve PPP risk management by fully implementing the current legal framework and revising inconsistencies with other relevant legislation.</td>
</tr>
<tr>
<td>Improve the analysis underlying the selection of PPP projects.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Natural hazards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhance coordination with macro-fiscal policies to support disaster resilience and mitigate output and welfare losses.</td>
</tr>
<tr>
<td>Improve the SDRFM by exploring alternative strategies to reduce potential financing gaps cost-effectively.</td>
</tr>
</tbody>
</table>


Note: DGCP = General Directorate for Public Credit; DGID = General Directorate for Decentralized Institutions; DMFAs debt management and financial analysis system; ENEE = National Electric Power Company; ESL = Electricity Sector Law; FRS = fiscal risk statement; FRU = fiscal risk unit; PPP = public-private partnership; SAMI = Integrated Municipal Administration System; SDRFM = Strategy for Disaster Risk Finance Management; SEFIN = Ministry of Finance; SIAFI = Integrated Financial Management System; SOE = state-owned enterprise.
Notes

1. The net assets of 15 of 16 fideicomisos (trust funds) that are part of the central administration and funded from the government resources represent 2.3 percent of gross domestic product in 2021. Assets and liabilities for other existing trust funds, including the number of trust funds, are either inconsistent or not disclosed. Note that fideicomisos are discrete legal entities representing funds operated outside the treasury to finance a public entity or a program. Funds may be financed from administrative transfers, appropriations, earmarked revenues, private sector contributions, or donors.

2. Whereas the authorities conducted an internal analysis of macroeconomic risks and their implication for fiscal variables, this analysis is not published. The authorities are performing calculations to determine specific risks for guarantees, litigation, and PPPs. Methodologies are being developed for other risks, such as public corporations and municipalities, but the calculations are not yet complete. International Monetary Fund (IMF), “Honduras: Technical Assistance Report–Fiscal Transparency Evaluation” (IMF Country Report 21/150, IMF, Washington, DC, July 2021).


4. Neither the 2021 FRS nor the Ministry of Finance website do not include any methodology notes on the estimation of risks from various sources, which impedes the comprehension of the numbers presented. For example, the notions of maximum exposure to specific CLs. The FRS omits also to discuss the likelihood of materialization of risks, the effects of CLs on the budget outlook, the risk factors beyond those related to PPP contracts, and how the risks could interact with each other, which is key as it helps to focus on risk mitigation efforts.

5. PPP contracts have financial implications and always pose fiscal risks for governments that need to be monitored and managed effectively. In the case of direct fiscal commitments, the need for payment commitments is known, even though there may be some uncertainty about the exact value of the payments.


7. Few renewal energy sources are available, even though these kinds of energy generation would increase cost efficiency and build resilience in the face of climate change.

8. Since 2016, EEH, a private international consortium, has been subcontracted by ENEE to manage the distribution network in an attempt to reduce losses by 17.0 percent and ENEE’s arrears by 19.5 percent (plus increase collections of payments).

9. EEH’s contract was established for seven years, starting its execution in 2016, with the objective of the expected loss reduction of 17.0 percent and a decrease in ENEE’s arrears of 19.5 percent. EEH did not achieve its objectives and argues that ENEE paid less than agreed, whereas ENEE argues that EEH never met the conditions to receive the payments.

10. The government decree established that the cost associated with the supply of residents consuming no more than 150 kWh/month would be partly covered as a cross-subsidy from the commercial and industrial tariffs and partly by the Ministry of Finance. Whereas this seems to imply a budget transfer to ENEE, yet no such transfer has taken place at the time this report was being prepared.

11. Tariff reform would not create net revenues because the tariffs are defined from a cost-recovery angle. Hence, a gradual cost recovery could limit the need for expensive bailouts from state budget. The fiscal impacts will depend on the reform path chosen by the government.
12. The amount of savings would depend on external factors (an increase in global oil prices will widen the gap between tariffs and costs) and internal determinants (the pace of reform implementation). Furthermore, implementing energy efficiency measures—such as replacing lighting equipment in the residential, commercial, and public sectors, as well replacing commercial and public air-conditioning and industrial engines—could generate reductions of 148.6 megawatts (8 percent of BAU in 2030) with consumers’ profit close to US$422.7 million by 2030. See World Bank, “Assessment on Energy Efficiency Potential and Demand-Side Management Opportunities in Honduras,” 2019. Further analysis on the fiscal impact of the ongoing reforms is necessary to guide policy recommendations.

13. The CAR is a measure of how much capital a bank has available, reported as a percentage of a bank’s risk-weighted credit exposures. The purpose is to establish that banks have enough capital on reserve to handle a certain amount of losses, before being at risk for becoming insolvent.

14. The capital shortfall decreases to negligible levels if some of the corporate NGDs are assumed to have an alternative FX hedge (for example, in the case of utility companies that have contracts that adjust on equal footing with the FX).

15. Natural hazards include geological, hydrological, meteorological, and biological hazards. Although Honduras has remained largely unaffected by the frequent earthquakes and volcanic activity that characterize other Central American countries, in 2009 a magnitude 7.1 earthquake killed seven people and caused estimated losses of US$100 million, including US$35 million in damage to infrastructure. World Bank, “Disaster Risk Management in Central America: GFDRR Country Notes: Honduras,” http://web.worldbank.org/archive/website01539/WEB/IMAGES/GFDRR_HO.PDF.

16. Based on data from the EM-DAT database compiled by the Centre for Research on the Epidemiology of Disasters (CRED, www.emdat.be), Honduras experienced at least 92 natural hazards between 1961 and 2021. Natural hazards in EM-DAT include droughts, earthquakes, epidemics, floods, landslides, mass movements (dry), storms, and wildfires. Although registered, the data on the impact of natural hazards is limited to 76 events (for number of people affected) and 27 events (for total damages).


19. H.-O. Pörtner et al., eds., Climate Change 2022: Impacts, Adaptation, and Vulnerability. Contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change (Cambridge: Cambridge University Press, 2022). The report estimates that the main climate change impact drivers in the Central American region—such as extreme heat, drought, relative sea-level rise, coastal flooding, erosion, marine heatwaves, ocean aridity, drought, and wildfires—are likely to increase by mid-century. It also projects an increased frequency of intense cyclones.

20. World Bank, “Honduras Country Climate and Development Report” (World Bank, Washington, DC, forthcoming 2022). Although no data on the exact effects of climate change on the impact of natural hazards in Honduras are available, simulation results illustrate that an increase in disaster severity would translate into an increasingly large increase in economic losses, further aggravating risk. In economic terms, increased intensity of events is more impactful than increased frequency.

natural hazards. More specifically, the analysis used the Caribbean Catastrophe Risk Insurance Facility (CCRIF) SPHERA, and XsR2.5 models to assess the contingent liabilities.

22. Loans to the private sector account for 59 percent of total banking sector assets, and most of the remaining assets are either cash or T-bills (25 percent) or longer-term government bonds (9 percent). Equity and bond exposure to the private sector is very small.


25. As part of the methodology, the Ministry of Finance will build a critical infrastructure database and overlay it with available country risk profile data, which will allow it to estimate explicit contingent liabilities due to natural hazard risk.

26. The Cat DDO instrument, created by the World Bank’s Board of Executive Directors in 2008, enables countries to immediately access a prearranged amount of funding upon declaration of a state of emergency due to a natural or climate-related hazard or health emergency.

27. Emergency relief involves immediate actions postdisaster that must be taken to assist affected people and to save lives (e.g., send rescue teams to affected zones, set out tents and field hospitals, and so on). In turn, recovery involves actions to restore the livelihoods of the affected population (such as restore infrastructure that was damaged, like bridges, hospitals, and schools; however, it does not mean reconstruction, but the reconditioning for a safety use).


29. Fiscal risk management is governed by regulations and procedures. In addition to the FRL, other legislation includes the 2004 Organic Budget Law, the General Provisions of the Budget Law, the 2002 Law of the Supreme Audit Court, the 2006 Transparency Law, the 2010 PPP law (revised in 2014), and SOEs’ specific laws. The sectoral laws’ secondary legislation supports the implementation of the laws, such as the 2013 Technical Norms of Public Credit.


32. For example, for the government, guarantees for ENEE borrowing or power purchase agreements; for ENEE, nonguaranteed borrowing, large investments.
3. Wage Bill Management

Ensuring better control over the aggregate wage bill is among the key challenges for Honduras in managing its public finances. Despite its efforts since 2013, Honduras still faces a wage bill as share of GDP that has remained high by international standards.¹ The lack of a coherent legal framework for public employment and of a clear remuneration policy and the existence of special regimes for occupational groups are the factors driving the unsustainable public wage bill in Honduras. The government’s capacity for implementation is limited and further exacerbated by poor information systems. This deficiency impairs the country’s ability to effectively plan and control expenditures on the public wage bill. Without such control, crucial to keeping public finances on a sound footing, the government is unable to gradually re-orientate public spending toward growth-enhancing expenditures.

Difficulties in accessing fiscal and employment data and issues of consistency between the aggregated and microdata provided by the government of Honduras limit the robustness and the relevance of the analysis in this chapter. In the future, important efforts should be undertaken to ensure that reliable data are available to enable better estimations of the costs of the wage bill.²
3.1. Honduras public wage bill in international perspective

Honduras’s public wage bill as percentage of GDP remains among the highest among peer countries, despite having achieved one of the steepest reductions in the public wage bill. Since 2013, the wage bill has declined by about 3 percentage points of GDP through the implementation of expenditure stopgap measures, including freezing wages and eliminating redundancies in public companies (which were largely overstaffed) as well as adopting managerial measures such as a central payroll system for the central government. Honduras’s wage bill remains higher than structural and aspirational peers and is still among the highest in Central America and Latin America (figure 3.1).³

The implementation of the FRL in 2016 reaffirmed the efforts to contain the growth in spending on the payroll. In 2019, the authorities established a ceiling of 7.2 percent growth on the budgetary central government current expenditure, in line with the FRL as part of Quantitative Performance Criteria under the IMF program (2019–22) to control current spending and limit the growth of wage spending.⁴

As a result of the high proportion that the public wage bill represents in both public spending and revenue, Honduras faces budget rigidity, which limits the stabilizing role of fiscal policy. During 2016–18, the wage bill accounted for about 40 percent of total

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**Figure 3.1. Public Sector Wage Bill Over Time as a Share of GDP for Peer Countries**

Source: World Bank staff calculations based on public sector wage bill expenditures data from the Worldwide Bureaucracy Indicators and GDP data from World Economic Outlook.

Note: CA = Central America; LAC = Latin America and the Caribbean.
revenues – higher than the Central American average (38 percent), the Latin America and the Caribbean average of 35 percent, and the structural peers average of 33 percent, limiting the opportunity to make alternative investments (figure 3.2). Despite a reduction in the share of the wage bill in total expenditures from 47 percent in the period 2006–10 to 39 percent in 2016–18, the wage bill is still higher than the average for countries in Central America and Latin America and the Caribbean (34 percent and 29 percent, respectively). During the same period, public wages explained around 39 percent of total spending in Honduras, whereas they accounted for about 31 percent for structural peer countries and 28 percent for aspirational peers. These high shares introduce rigidities in fiscal spending and limit the capacity of the government to face the multiple shocks (health and climate related) that the country frequently faces.5

Employment in the public sector as a share of formal employment is below international benchmarks, suggesting that the high public wage bill is driven by the level of salaries. Public sector employment accounts for roughly 6 percent of total formal employment in Honduras, which is lower than in peer countries. At the same time, the level of public sector wages, measured by the earnings ratio between public and private hourly wages, is higher than in other countries (figure 3.3). The public-to-private earnings ratio is more than two in Honduras, the second highest in Latin America, potentially crowding out talent from the private sector. The high wage bill hinders the reallocation of resources to improve service delivery, limits the space for discretionary fiscal policy in the event of an emergency, and increases fiscal risk given the multiple salary negotiations that take place with organizations representing different labor regimes each year. Therefore, restructuring the personnel management system to improve the quality of services is essential for achieving the government’s objectives.

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Figure 3.2. Public Sector Wage Bill over Time for Peer Countries

A. Share of total revenues

<table>
<thead>
<tr>
<th>Year</th>
<th>Honduras</th>
<th>Structural average</th>
<th>Aspirational average</th>
<th>CA average</th>
<th>OECD average</th>
<th>LAC average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-5</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>22</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2006-10</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>27</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>2011-15</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>22</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2016-18</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>17</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>

B. Share of total expenditures

<table>
<thead>
<tr>
<th>Year</th>
<th>Honduras</th>
<th>Structural average</th>
<th>Aspirational average</th>
<th>CA average</th>
<th>OECD average</th>
<th>LAC average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-5</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>22</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2006-10</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>27</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>2011-15</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>22</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2016-18</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>17</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>

Source: World Bank staff calculations based on public sector wage bill expenditures and total expenditures data from the Worldwide Bureaucracy Indicators and total revenues data from World Economic Outlook.

Note: CA = Central America; LAC = Latin America and the Caribbean; OECD = Organisation for Economic Co-operation and Development.
3.2. Recent developments and trends in the wage bill

Overall, the public expenditure profile in Honduras is skewed toward current expenditures and the public wage bill is the main category of spending. Personnel-related expenditures amounted to 12.2 percent of GDP in 2020 and accounted for close to 36 percent of total outlays, which is the largest expenditure item. This expenditure represents a decline of close to 2 percentage points of GDP compared with the 2013 peak (figure 3.4). Likewise, capital expenditures do not show a tendency to grow and have remained below 6 percent of GDP during the past decade.

Expenditure on salaries accounted for almost 12 percent of GDP in 2021 with almost 70 percent of spending at the central administration level. Honduras’s NFPS employs approximately 207,200 people and devotes around $3.2 billion to wage bill expenditures (table 3.1). The central administration represents 78.3 percent of NFPS employment and 68.3 percent of the wage bill. Central administration civil service is mostly composed of employees of the education sector (37.6 percent), security and justice sectors (24.3 percent), and health sector (10.5 percent).

During 2017–19, the highest growth in wage bill took place in local governments (37.7 percent), while the central government increased by 4.1 percent (figure 3.5a). Within specific sectors of the central administration, the education sector wage bill increased by 5.8 percent throughout the period, with a small increase in staffing and an increase in average wages of 5.2 percent (figure 3.5). Following a different trend, the health sector experienced an increase in staffing of 8.7 percent, and a decrease in average wages of 5.8 percent, creating an overall increase...
of the wage bill of 2.3 percent (box 3.1). These uneven trends are one of the consequences of the weak resource management framework characterized by the lack of planning and a reactive approach to requests for salary increases.

**Wage bill expenditures in Honduras were greatly affected by the COVID-19 crisis.** Before the pandemic (2017–19), Honduras’s NFPS increased its wage bill expenditures by 5.7 percent, with almost all the increase devoted to salary readjustments. In 2020–21, during the pandemic,

**Figure 3.4. Public Wage Bill Evolution**

a. Evolution of public expenditures as a share of GDP (2010–20)  
b. Structure of public expenditures in 2019–20

Source: World Bank staff calculations based on data from SEFIN.

**Table 3.1. Public Employment and Wage Bill in Honduras, 2021**

<table>
<thead>
<tr>
<th>Remuneration</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dollars</strong></td>
<td><strong>Percentage</strong></td>
</tr>
<tr>
<td><strong>(millions)</strong></td>
<td><strong>of GDP</strong></td>
</tr>
<tr>
<td>Nonfinancial public sector</td>
<td>3,235</td>
</tr>
<tr>
<td>Central government</td>
<td>2,905</td>
</tr>
<tr>
<td>Central administration</td>
<td>2,211</td>
</tr>
<tr>
<td>Education</td>
<td>1,038</td>
</tr>
<tr>
<td>Health</td>
<td>378</td>
</tr>
<tr>
<td>Security and Justice</td>
<td>445</td>
</tr>
<tr>
<td>Other</td>
<td>350</td>
</tr>
<tr>
<td>Decentralized institutions</td>
<td>333</td>
</tr>
<tr>
<td>Social Security institutions</td>
<td>169</td>
</tr>
<tr>
<td>Deconcentrated institutions</td>
<td>192</td>
</tr>
<tr>
<td>Local governments</td>
<td>152</td>
</tr>
</tbody>
</table>

Source: World Bank staff calculations based on information from SEFIN.
Health sector wage bill expenditures in Honduras increased by 36.1 percent in 2021, when compared with 2020. With the outbreak of the COVID-19 pandemic, governments have focused on health sector expenditures to strengthen their capacity to handle the pandemic. This expansion is represented in investments for health care infrastructure, such as increased number of intensive care beds, respiratory-support machines, testing kits, and so forth, as well as hiring additional doctors and nurses.

Increases in the wage bill expenditures in the health sector were mainly caused by additional staff hiring, rather than average wage increases. From 2018 to 2020, the health sector personnel saw an average real increase in wages of about 0.6 percent per year and a scaling down in the number of staff of 1.9 percent per year. In 2021, average wages increased by 3.9 percent after inflation, and the number of employees surged by 30.9 percent, going from around 20,000 employees to almost 26,000.

The hiring of around 6,000 employees in the health sector in 2021 was concentrated in positions for doctors and nurses and was mainly a result of an increase of temporary job positions. In 2021, the number of doctors and nurses in the public sector increased by 47 percent, with these two groups of positions alone being responsible for three-fourths of the new additions to the health care personnel. 93 percent of these new positions were filled with temporary job contracts.

Figure 3.1.1. Health Sector Wage Bill Expenditures over the Years

- Change in wages bill, wages, and staff
- Change in staff by career
- Change in staff by contract type

Source: World Bank staff calculations based on data from SEFIN.

* These careers were defined using common strings from notional position (puesto nominal) classification, such as “medica,” “enfermero,” and so forth.
NFPS wage bill expenditures increased by 6.3 percent. The same pattern occurred for the central government, where an increase in wage bill of 4.1 percent took place before COVID-19 and of 6.8 percent during the crisis (figure 3.5). The health sector was the main driver of the rise in wage bill expenditures during the pandemic with the overall wage bill increasing by 26.1 percent in the sector, mostly because of an increase in recruitment of 15.8 percent.

3.3. Other limitations and opportunities

High levels of spending on wages limit fiscal policy and generate crowding-out effects, especially in low-income countries. The literature indicates that the level of the wage bill tends to increase with the wealth of the country or the level of development, as productivity growth explains wage growth. Although Honduras has made progress in limiting current spending through the FRL, it has not tied its public employment policy to rules such as those based on merit, performance, seniority, and so forth. Thus, the government retains certain discretion that
discourages long-term policy planning. Additionally, during times of fiscal tension, high wage bills—and therefore greater budget rigidity—tend to crowd out public investment, which usually represents a low proportion of the public budget but has a strong impact on economic growth.\(^7\)

It is essential to channel resources toward their most productive use and to those that can contribute to the economic growth of Honduras. The World Bank’s *Recovering Growth* report states that there is substantial space to switch from inefficient government spending to spending that contributes to growth.\(^8\) According to Izquierdo, Pessino, and Vuletin (2018),\(^9\) estimated inefficiencies in procurement, civil service, and targeted transfers in Honduras represent a waste of 4.6 percent of GDP. In particular, the estimated inefficiencies in the civil service in Honduras represent around 2.7 percent of GDP, the second largest wage bill inefficiency in the region (after El Salvador). This may suggest that part of this wage bill premium may be due not to higher skills but to higher union density in the public sector and to political economy considerations (see figure 1.21 in chapter 1).

Despite Honduras’s high wage bill, the country has potential to readjust wage bill policy. The *Budget Rigidity in Latin America and the Caribbean* study\(^10\) finds that the structural component of the public wage bill has decreased over time in Honduras. The study’s authors propose a new measure of expenditure rigidity involving two components: a structural component (determined by long-term economic fundamentals) and a nonstructural component (conditioned by shorter-term policy decisions). In their view, the first component implies greater rigidity in the public budget and less in the policy maker’s control over spending. The study reveals that the structural component of the wage bill in Honduras has been decreasing from 2000 to 2017 and is the lowest in the Central America region (figure 3.6). Changes in the proportion of the structural component in the wage bill over time may indicate the presence of heterogeneity in the management of public wages. Honduras seems to be moving toward a less rigid scheme—from about 80 percent of the structural component in 2000 to 50 percent and 60 percent in 2010 and 2017, respectively—suggesting a decreasing trend over time and, thereby, additional flexibility in the wage bill management.

### 3.4. Institutional context and a road map for civil service reform

Strengthening of the institutional framework for the civil service is needed to fill the existing gaps in human resources management, to guarantee the success of the government’s strategic planning function, and to support fiscal sustainability. The purpose of human resource management is to adapt people to the strategy of the government or its institutions to produce results in accordance with the public objectives. Although the amount of personnel spending is a fundamental resource for the provision of public services, governments require effective control over global remuneration and the workforce, which must be qualified, motivated, and productive. In this sense, it is important to generate an appropriate legal and institutional framework that considers fiscal sustainability and provides flexibility to channel resources to priority areas.

The government of Honduras could greatly benefit from a comprehensive reform of the public employment framework. Honduras could consider unifying employment regimes, creating
Figure 3.6. Structural Component of the Public Wage Bill as a Percentage of the Actual Wage Bill in LAC, 2000–17


Note: LAC = Latin America and the Caribbean.

A framework that provides certainty both in the management of human resources and in salary compensation. An adequate, flexible, and transparent institutional framework would help the hiring of personnel based both on the needs of the government to fulfill its functions and achieve its goals and on the needs of public organizations. At the same time, it would promote access to suitable personnel. Within this reform, labor organizations deserve special emphasis, given their role and influence in collective bargaining. Collective bargaining should be part of a salary policy based on merit and not a mere salary increase. A collective bargaining model must be developed for the public sector that defines the rights already acquired and that outlines the conditions and procedure to carry out negotiations in such a way that allows for a longer horizon of stability for the government on salary budgets.

Honduras’s existing public employment and remuneration framework is characterized by structural features that undermine government effectiveness. The public sector comprises multiple entities and organizations at different levels of the state and several parallel regimes for employees and institutions, thus leading to a fragmented and often ambiguous institutional setting that precludes unified management of wages and gives rise to discretionary salary adjustment mechanisms. The legal framework is seriously outdated (Civil Service Law from 1968) and does not define clear criteria for its applicability to certain groups of public sector employees. This architecture is also challenged by weak institutional arrangements, whereby there is virtually no high-level public administration authority responsible for human resource policies in the public sector.
In their policy dialogue with IMF (2020-21), authorities stated that they will upgrade the General Directorate of Civil Service (DGSC) to a public administration authority over the medium term. The new DCSC would be in charge of reforms to “right-size” the number of labor regimes existing in the public sector and to establish a modern civil service career aligned with merit and performance. However, practical measures have yet to been taken in this direction. DGCP advanced some actions to automate several of its procedures to ensure business continuity during the COVID-19 pandemic, but much more is needed to make solid institutional reform in the sector. Capacity for implementation is limited by the lack of adequate skills, poor information systems, and scant resources available to ensure comprehensive coordination of human resources management, including accountability for public sector employees.

In 2020, Honduras also designed and approved a central mechanism for salary negotiations to guide decisions on nominal wage increases, in line with the FRL. The new mechanism covers all employees from the central administration and decentralized entities, including those under special regimes such as for teachers and health care workers. The decree has been approved by the Council of Ministers but has not yet been published in the official gazette, and hence its implementation is pending. The new mechanism should help contain the wage bill and support convergence to the FRL’s current spending and deficit ceiling as the crisis subsides.

The lack of disaggregated, reliable, and accessible data increases the challenges in the management of the wage bill and the human resources system. Multiple information management platforms are not or are only partially interconnected and hold incomplete information about employment in different government agencies and levels and associated salaries and benefits. This fragmentation complicates the planning and budgeting process as well as the control measures for wage bill management.11

Comprehensive and all-encompassing human resources management reform is necessary but challenging from the political, fiscal, and institutional perspectives. To advance the effort to tackle the structural problems of the system, the new administration should take an approach that considers the different dimensions of a well-functioning, professionalized, and responsible public sector employment system. A reform of this nature may encounter resistance from political and even labor organizations, because it must also include planning and policy making based on the analysis of reliable data; jobs management and distribution; hiring and career management; compensation; performance management; and human and social relations management.

This PER has identified some measures that could be sequenced to strengthen the civil service and, in general, of public sector employment. They are grouped as measures that could (a) have positive effects on the leadership of the civil service and public employment in general; (b) address the challenges of improving the profile and the technical skills of the employees, in relation to the responsibilities assigned; (c) contribute to the rationalization, balance, and sustainability of the wage bill; and (d) would create an environment more conducive to the development of a more professional and responsible public employment system.
Civil service management

Honduras has multiple laws that regulate employment relations within the public sector. The legal framework includes (a) the Civil Service Law from 1968, (b) the Municipal Administrative Career Law from 2010, (c) the Labor Code from 1959, and (d) Education Reform from 2011, which unifies the regulations applicable to teachers. In addition to these legal acts, Honduras has eight professional regimes (estatutos profesionales) that regulate labor relations between different groups of professionals and employers, both from the private and public sectors.\(^\text{12}\)

As a result of this fragmented legal framework, Honduras lacks a civil service authority responsible for human resource policies in the public sector. The DGSC, dependent on the Ministry of the Presidency, has authority over employees of the central government administration—line ministries and central agencies—but does not exercise authority over public employees of autonomous agencies, municipalities, teachers, daily-wage and under-special-regimes employees. In addition, its position in the government structure (figure 3.7) places it below the ministries, which limits its influence over them.

Figure 3.7. Placement of the General Directorate of Civil Service within the Government Structure

![Diagram of the General Directorate of Civil Service within the Government Structure.](source: Translation from source at Instituto de Acceso a la Información Pública (IAIP), Potal Unico de Transparencia.)
The lack of resources, in addition to an inappropriate legal framework, partially explains the DGSC’s inability to fully exercise its powers. The DGSC is affected not only by the lack of administrative autonomy but also by the lack of human, budgetary, and technical resources, among others, to carry out its planned actions. These limitations are reinforced by other factors such as (a) parallel regimes, (b) a multiplicity of rules for wage setting, (c) special provisions for hiring without selection processes or without clear wage parameters, (d) specificities in working conditions and wages born of collective agreements without clear monitoring of the costs and obligations they generate, and (e) inefficient records and information systems. As a result, the DGSC is not empowered to carry out a technical-political process of the magnitude of the reform required for the civil service.

To improve the management of the civil service for the short, medium, and long term, some measures could be adopted according to the government’s priorities. The actions are prioritized depending on their complexity and feasibility in the sociopolitical-institutional context of the country (see details in appendix H). For the short term, the measures to be adopted are (a) redefining the location of DGSC in the government structure to upgrade it to a public administration authority and (b) strengthening its technical and operational capacity. The DGSC should be a decentralized public body, closely linked and collaborating with the Ministry of Finance, with the goal of tightening mechanisms for coordination with treasury affairs. In the medium term, the following measures need to be adopted: (a) improving data records and integrating information systems to allow for analysis and decision-making based on human resource management information and not only on (incomplete and insufficient) data on remuneration, (b) developing a program to strengthen human resource offices in public agencies, and (c) developing a census and institutional audits program implemented by DGSC to verify compliance with human resource regulations. In the long term, measures to be adopted include (a) harmonizing and integrating the multiple regimes (estatutos) and (b) adjusting regulations as steps toward passing a new civil service law.

Quality of human resources

The performance of the public sector in Honduras is constrained by the quality of its human resources. The government has no personnel management practices that guarantee quality in recruitment, the employees do not always have the required technical or professional skills, and the human resource management units of public agencies, in turn, lack sufficient training or the necessary technical instruments to adequately perform their role.

Only a few Honduran public institutions have an inventory of positions or job profiles. The job positions are not clearly established and even when manuals are in place they do not correspond to the job inventory. In turn, DGSC’s Manual of Classification of Positions is outdated and lacks homogeneity among public bodies. The lack of job manuals limits the perspectives of career trajectories within the public service. Rules for career paths established in the law are not applied, so it is difficult for agencies to recruit and select suitable personnel and evaluate their performance. Although the Civil Service Law establishes the procedure for selecting public servants and sets DGSC’s responsibility to ensure that openings receive publicity and are filled using merit selection criteria, studies reveal a lack of coordination and communication, as well as missing information on levels of participation in competitive selection processes.
Because of these weaknesses, it is unknown where the gaps are between the skills and training of public employees and what the positions really demand. Although the DGSC has made efforts to strengthen the capacities of civil servants through training and by promoting the creation of the School for Public Servants, these efforts may remain as isolated initiatives with no considerable impact because they do not respond to real skill gaps for the jobs of public institutions.19

Civil service management needs effective monitoring process and control mechanisms throughout all its dimensions. Civil service management must count on complete and reliable information to effectively monitor all the coexisting labor regimes. Reliable information is needed that allows for monitoring public employment, including all regimes and the recruitment, selection, training, and performance evaluation of public employees.20 The job manuals and their classifications should be incorporated into the job catalogs that currently exist, the Employees Registration and Control System (SIREP) or the Human Resources Administrative Information System (SIARH), to guarantee the reliability of the information.21

Improving the quality of human resources entails closing information gaps and gradually standardizing civil service processes and procedures. In the short term, the recommendations are to (a) develop and approve the jobs manual and (b) identify employees’ skill gaps and put in place corresponding training programs. In the medium term, some career paths should be selected to test an application of a controlled complete implementation of civil service procedures. In the long term, for all hiring, improvements are needed in (a) the process of recruitment and selection and (b) tools and practices for performance evaluation.

Rationalization of the work force and its costs

The persistent burden and high cost related to inefficiencies in the civil service demand additional action to rationalize the cost of the work force. The different hiring mechanisms and regimes result in high heterogeneity in the civil service, with concurrent variability in the salary structures, because salaries are defined without objective criteria and are highly discretionary.22 Despite all the described efforts, such as establishing ceilings aligned with the FLR and designing a new central mechanism for salary negotiation, there is still important room for improvement to bring Honduras to the wage bill level—as a percentage of the GDP—of its structural and aspirational peers. However, political constraints as well as lack of robust data to infer analytic models affect decision making. This study offers a sectoral analysis for the wage bill in the education sector, despite all the challenges faced with data limitations. Additional efforts need to be collected and data need to be consolidated to advance further analysis in a way that provides enough information to properly assess alternatives for reinforcing wage bill management.

Additional studies could be considered to inform future policy-making decisions geared at efficiency gains. In the short term, it is recommended to undertake a study on the cost of anticipated retirement programs compared with compensation for voluntary withdrawal. The latter tends to be a better alternative to reduce wage bill costs with less pushback. Furthermore, a map of salary equivalencies under the different labor frameworks needs to be developed to start identifying clusters or nodes of salary ranges and to promote a progressive ordering of the types
of jobs included in each node. Such ordering of job types is needed to inform starting salaries for new hires and to introduce some order for the long run.

The implementation of the central salary negotiation mechanism can be the foundation for working toward a robust remuneration policy. The negotiation mechanism can be reinforced by developing rules to define multiannual global negotiation caps for the entire public sector and by distributing the funds for negotiation purposes among the sectors/agencies where these negotiations occur. An encompassing measure will be to adopt a remuneration policy that includes a fiscal framework for negotiation with the labor organizations and that sets limits for such negotiations. This is a complex measure from the political point of view; therefore, it should be considered as a long-term measure taken after advancing foundational efforts toward a consolidated remuneration policy for all public employees.

**Transparency and integrity in the management of the civil service system**

The practices described in the operation of the civil service system create opportunities for clientelism and favoritism in human resource management. Public institutions lack skilled employees; operate in the absence of sound recruitment, evaluation, and training processes; pay salaries that do not respond to market conditions; and there are no rules regulating revolving door practices and conflict of interests. The selection and retention processes for public employees in Honduras are discretionary, scarcely transparent, and implemented with little or no coordination by the DGSC, which is supposed to provide oversight.

A transparent mechanism in human resource management is needed to reduce political influence and conflict of interests. Clear and explicit rules should be implemented from the beginning of the civil service reform effort to support the establishment of transparent recruitment processes based on merit that start with public calls for applications to available positions and continue with publicly available information on the results of recruitment. The government could create a website with aggregated information (monitoring indicators) on compliance with public employment rules for the different employment regimes and should include information regarding which public employees hold decision-making positions as well as information on selection processes to be properly controlled and overseen. There should be a legal obligation to keep this information updated, with sanctions established for lack of compliance.

**Road map for civil service reform**

A potential road map with the corresponding sequencing of implementation of potential reforms is included in figure 3.8. Figure 3.8 summarizes the set of reforms that can help strengthening the civil service, displaying in different colors short-term, medium term and long term reforms and highlighting the interconnectedness of these measures. Some critical factors for the success of Civil Service Reform are described in Box 3.2 that outlines strategies implemented in Korea, UK, and select countries in Latin America and Caribbean Region.
Figure 3.8. Road Map for Civil Service Reform

- **Civil service management**
  - Redefine DGSC location
  - Grow and strengthen DGSC capacities
  - Develop and implement an information system for civil service
  - Program to strengthen HR offices
  - Institutional census and audit programs

- **Human resources quality**
  - Develop and approve the job positions manual
  - Verify, identify gaps, and implement training programs for regularization of positions
  - Select certain “career paths” and create a controlled CS implementation space to enable monitoring by DGSC
  - Improve recruitment and selection process for all types of contracts
  - Improve performance evaluation instruments and practices

- **Rationalization of payroll and its costs**
  - Salary policy
  - Study on early retirement cost vs. voluntary withdrawal compensation
  - Salary equivalents
  - Develop and approve collective bargaining legislation

- **Transparency and integrity in civil service management**
  - Strengthen transparency mechanisms in HR management to reduce political manipulation

Source: M. Ugarte, Hoja de Ruta: Medidas para la mejora de la gestión de los recursos humanos en el Gobierno Nacional de Honduras (Lima, World Bank, 2021).
Box 3.2. Learning from International Experience: Critical Factors for the Success of Civil Service Reform

A dated but very successful example of civil service reform is the one from South Korea in the 1960s, where the government established a highly competitive and open system for the recruitment of employees for higher and lower positions in the civil service based on testing. At the same time, the government set up a policy of internal promotion to reduce the number of appointees. Following this strategy, the Korean bureaucracy recruited the best students from the country based on the social prestige associated with public sector jobs.

According to the analyses conducted by the UK Institute for Government in 2014 on four successful civil service reforms implemented in the past 25 years in the country, there are several commons positive impacts of reforms: (a) a stronger sense of personal responsibility and accountability for delivery; (b) the use of objectives, performance indicators, and measurements to make progress transparent; (c) more open competition for senior roles and greater diversity of the Civil Service; (d) more value given to the quality of leadership and management; (e) a more outward-facing organization connected to the other organizations, perspectives, and ways of thinking to inform the policy development process; (f) learning and adoption of new ways of working, which outlasted the reform that introduced them; and (g) transitions that played a critical role in the life cycle of reforms. Common success factors that were critical at different stages of a reform life cycle were these:

Prepare and take-off
- clarity around the reform idea and purpose
- personalized leadership
- the right degree of political support
- ambitious, while connecting with departmental priorities
- the support of, or at least no opposition from, the Treasury

Deliver and refresh
- a dedicated and diverse team to drive the vision and the model
- a balance of compulsion with collaborative values
- the right use of accountability and governance
- management of critical transitions

Embed, limp on, or close down: creation of a lasting coalition of leaders around reform

The findings from the experiences in Latin America, based on the results of the performance measurements of civil service carried out by the Inter-American Development Bank between 2004 and 2012 in 16 countries, show that the most remarkable progress was achieved by countries that applied a variety of sequenced actions. Some of those stand out:

- Paraguay implemented its public employment law (Law 1626/2000) by mid-2008, when the newly elected government included it in its agenda. The government developed programs to strengthen professionalization, transparency, and inclusion of the public service by implementing management tools like workforce planning, job descriptions, information systems, pay scale, and payroll management. Despite all this progress, not enough attention was paid to the disconnection between the Civil Service Authority and the Treasury Authority, which in cases has led to the creation of management bodies and positions with the sole purpose of increasing salaries.

(continued)
In the 2000s Peru went from wages and normative dispersion, poor strategic planning, and weak institutional capacities to gradually implementing reforms in the organization and administration of the salaries of the groups with the major numbers of servants such as teachers, administrators, and health workers. By 2008, Peru created the National Civil Service Authority (Autoridad Nacional del Servicio Civil), the Public Managers Body (Cuerpo de Gerentes Públicos), and a new set of rules for training civil servants. Congress approved a new civil service law, Law #30057, in July 2013 and began to implement the organization of job descriptions, the updating of office operations manuals, and access through meritocratic competitions in some management positions.

In contrast, an example that should not be followed is the reform path undertaken in Bolivia. When the first assessment took place (2004), the government was developing rules and technical tools and promoting pilot projects to modernize agencies and services under the leadership of the Civil Service Superintendency. However, from 2006 onward, governments have changed competitive hiring for other selection criteria and, most importantly, have reduced the level of authority of the Civil Service from an autonomous agency with ministerial rank (Superintendencia) to a General Directorate under the Vice Ministry of Employment, Civil Service and Cooperatives of the Ministry of Labour, Employment and Social Welfare, taking away its power and independence. All of that affected the merit criteria, weakening staff skill levels.


c. These reforms were Next Steps (1987-97), Bringing In and Bringing On Talent (1999-2002), Public Service Agreements and the Prime Minister’s Delivery Unit (1998-2010) and Capability Reviews (2005-12).


3.5. Analysis of the wage bill in education

Honduras spends more on education than its structural and aspirational peers both as a share of GDP and as a share of total expenditures, but the impact of this investment remains limited. Despite the high level of expenditure in this sector, Honduras faces important challenges related to the effectiveness and quality of its education system and efficiency of spending. Over the past decade, the country has make some progresses, but it is still placed 40 percent above structural peers and more than double the level of aspirational peers (figure 3.9, panels a and b). Along with the higher level of expenditure in education, Honduras devotes a larger share of those expenditures to the compensation of teachers when compared with peers. Whereas Honduras
spends 72.9 percent of the total expenditures in public educational institutions to teachers’ compensation, structural peers spend 57.7 percent and aspirational peers spend 47.6 percent (figure 3.9, panel c).

Honduras managed to decrease its student-per-teacher ratio over the past couple of decades, reaching lower student-teacher ratios during the 2011–16 period relative to aspirational and structural peers (figure 3.10, panel a). This ratio is partly explained by an increase in hiring in the public education sector. From 2007 to 2021, the number of teachers employed by the Honduras public sector increased by 8 percent, an annual increase of 0.6 percent. Aggregate data for the education sector provided by SEFIN indicates that this general rising trend has changed in the past four years, with the number of civil servants in 2020 amounting to a number similar to what it was in 2017—approximately 77,900 employees (figure 3.10, panel b). In 2021, public payroll spending accounted for 78.6 percent of total public expenditures in the sector, after peaking at 79.2 percent in 2020. Whereas increasing the number of teachers can help reduce the

Figure 3.9. Education Expenditures over Time

a. as a share of GDP

b. as a share of total expenditures

c. Teaching staff compensation as a percentage of total expenditure in public educational institutions, 2011–15 average percentage


Note: CA = Central America; LAC = Latin America and the Caribbean.
student-per-teacher ratio, it also implies that the education sector budget has less room for public investment in the sector.

**Given its budget constraints and the inefficiencies present, the government needs to make smart expenditure decisions because public investment on infrastructure also is important to improve educational performance.** According to SEFIN, between 2019 and 2021 public investment represented on average 5.8 percent of GDP. Of total public investment, less than 4 percent goes to the education sector. Considering that, on average, between 2015 and 2020 the Honduran government managed to execute around 80.1 percent of what was budgeted for public investment, it can be estimated that a very small amount of what is budgeted and currently executed ends up in public investment in education.

**Honduras’s public sector wage premium in education was high by international standards for more than a decade, but in recent years it has been sharply reduced.** Honduras public school teachers have higher compensation than peers. Honduras’s public sector wage premium in education was 30.9 percent in the period 2011–15 and was reduced to 9.6 percent in the 2016–18 period (figure 3.11, panel a). When compared with peers, these data suggest that Honduras was able to reduce its premium to levels well below Central America and Latin America and the Caribbean averages. When comparing the standard of living of Honduras teachers with peers using purchasing power parity–adjusted compensation, the data show that in Honduras teachers earn more than the global median, as well as more than comparators (figure 3.11, panel b). Even though Honduras’s primary school teachers receive 20 percent more than the global median, and secondary school teachers earn 30 percent more than the global median, Honduras faces important challenges related to the effectiveness of its education system. As evidenced by national and international data on student achievement, the performance of Honduran students

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**Figure 3.10. Honduras Education Public Sector Wage Bill over Time**

a. Pupil-teacher ratio over time for peer countries

<table>
<thead>
<tr>
<th>Year</th>
<th>Honduras</th>
<th>Structural Average</th>
<th>Aspirational Average</th>
<th>CA Average</th>
<th>LAC Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-5</td>
<td>40</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>2006-10</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>2011-15</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>2016-18</td>
<td>15</td>
<td>10</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

b. Drivers of Honduras education sector wage bill variation over time

- Wage bill
- Average wages
- Civil servants

**Source:** World Bank staff calculations based on data from Education Statistics—World Bank (EdStats) and SEFIN.

**Note:** CA = Central America; LAC = Latin America and the Caribbean.
in reading, math, and science is slightly below the Latin American and Central American averages (figure 3.11, panel c), however are better than peers.

**Key characteristics of teachers’ wage bill**

Between 2007 and 2021, wage bill expenditure on teachers rose 1.1 percent per year in real terms, although this does not respond to any observable remuneration policy. This annual growth was made up of a 0.5 percent increase in average wages and a 0.6 percent increase in the number of teachers. Between 2007 and 2012, payroll growth (3 percent per year) was largely driven by wage increases (2 percent per year). That trend changed in 2013, and until 2017 the teachers’ wage bill had a yearly decrease of 0.3 percent with average wages shrinking at an annual rate of 1.2 percent while the number of employees increased by 0.9 during the same period. However, in the following years (2018–21) Honduras’s teachers’ compensation
expenditures rose at a rate of 0.5 percent per year. That increase was a consequence of the real wage rises (0.9 percent per year) (figure 3.12).

**Primary school teachers are better compensated than secondary school teachers in Honduras.** Teachers’ Administration System (SAD) data indicate that teachers are distributed across five main groups: directive and administrative positions, preschool, primary, secondary, and others (adult schooling and remote schooling). The majority of teachers work in primary education, representing 59.3 percent of all teachers and 62.2 percent of the teachers’ wage bill. The second largest group are secondary education teachers, comprising 22.4 percent of all teachers and 20.6 percent of the wage bill (figure 3.13).

There has been a significant number of new additions to the temporary staff in the education sector over the past few years. In 2021, temporary teaching staff accounted for approximately 20 percent of the total teaching positions in 2021. A similar expansion appears to have occurred 5 and 10 years ago with permanent teaching staff, reflected by the spikes in specific cohorts of teachers (figure 3.14, panel b). According to the SAD microdata, the average tenure of Honduran teachers is 15 years, yet 25 percent of the teachers have at most 3 years of service. The age of teachers follows a normal distribution, with an average age of 46 (figure 3.14, panel a).

Over the past years, Honduras has shown a high turnover of teachers (figure 3.15). SAD microdata shows that from 2009 to 2010 Honduras hired approximately 5,000 teachers, which
Figure 3.13. Wage Bill and Employment Distribution across Career Groups, 2021

a. Wage bill

b. Employment

![Pie charts showing wage bill and employment distribution across career groups.

Source: World Bank staff calculations based on data from SEFIN.

Figure 3.14. Teachers’ Age and Tenure in 2021

a. Teachers’ age

b. Teachers’ tenure

![Bar charts showing teachers’ age distribution and years of service.

Source: World Bank staff calculations based on data from SEFIN.
represented an annual recruitment rate of 0.84 percent. Since 2019’s peak, the number of total teachers has been shrinking at a rate of around 1 percent per year, ending 2021 with a total of more than 61,000 teachers. Besides this recent trend, the share of new teachers that entered the civil service during the 2009–21 period was 3.7 percent per year on average, and the share of teachers that left was 3.2 percent, totaling a 6.9 percent turnover of civil servants per year.

The analysis of the microdata indicates that inequality in teachers’ compensation is larger at the beginning of the career (figure 3.16). This is partially explained by the lower wages of temporary positions, especially the interinos. In 2021, this group of temporary teachers represented 19 percent of total teaching positions, and they had an average tenure of 2.4 years. Half of these teachers were working for one year or less. When comparing the interinos’ hourly wages with the ones received by tenured teachers with similar years of service, the data show that interinos receive 11 percent less than permanentes (tenured teachers).

**Microdata simulations for teachers’ wage bill**

This section presents projections for the teachers’ wage bill to help inform Honduras about potential savings under various policy scenarios and how the data could be used to inform decisions about the cost of the wage bill. The performance of the simulations relies heavily on the quality of the data that is fed into the model. Because the exercise required several assumptions, this PER does not make specific recommendations but aims to illustrate options that would require further validation to guide more effective policies. It also intends to illustrate the potential of using modeling data to develop inputs for decision-making and to encourage actions that improve data quality to realize such potential in the future.

To forecast teachers’ wage bill expenditures, this PER developed a human resources microdata-based model that leverages the SAD data. The full dataset used for the simulation gathered two batches of data. The first one was shared with the World Bank staff in the 2018
report, focused on wage bill expenditures, and comprised all teachers registered in SAD from 2007 to 2017. The second batch of microdata was obtained in 2021 and contained SAD microdata for the months of March, June, and November of the years 2017–20, along with the month of March of 2021.

**Given the limitations of the data, several assumptions were made to run the analysis.** In particular, the baseline “business as usual” simulation considers several assumptions using the SAD microdata from 2007–21. These assumptions include the following:

- Extrapolation of the years of service variable is available only in the first batch of data.\(^{32}\)
- Teachers work all position-based working hours.
- Permanent and temporary positions have the same career structure.
- Average wage bill growth is from 2007 to 2021.
- Probability distribution of retirement considers that starting at age 60 for females, and at age 65 for males, the positive probability of retiring reaches 100 percent at age 70.
- The average replacement rate is 0.84 (for every 100 employees that leave civil service, 84 new employees are hired).
- Teachers are grouped into five career clusters—namely, administrative positions, preschool education, primary education, secondary education, and others (adult schooling and remote schooling).
- Net of inflation compensation increases amounts to an average of 1.54 percent per year based on the 2007–21 period.

**Given the average replacement rate of 0.84 over the past four years, the teachers’ wage bill is expected to grow annually approximately 0.73 percent in real terms, on average, for the coming five years (figure 3.17).** Despite the effort to control the wage bill in the past few years, which included reducing the total number of positions from around 72,000 in 2017 to approximately 69,000 in 2021, the payroll is expected to increase from an estimated US$900 million in 2022 to US$982 million by 2026 (2021 price levels) if a baseline scenario of “business as usual” is followed.

**Along with the baseline scenario, additional policy scenarios were simulated to help inform Honduras about the potential fiscal savings in the teachers’ wage bill.** The following scenarios were simulated:

- Scenario 1 considers reforms based on reducing the replacement rate, showing that this can have considerable effect on the wage bill without affecting the currently employed civil servants, and with mild impacts on student-teacher ratios (STR). In the scenario in which the replacement rate is reduced by half of its current level (figure 3.18), the fiscal savings can go up to US$60 million (2021 prices) over the next five years, totaling 0.23 percent of GDP. From 2009 to 2020, the average replacement rate was 1.00 to 0.84. In fact, our estimates suggest that in the next five years 11 percent of the currently employed teachers in Honduras civil service are expected to retire. This policy scenario has a direct effect on STR by increasing the number of students per teacher, all else equal. In 2021, Honduras had an STR of 25.5 students
Figure 3.17. Baseline Wage Bill Projection

Source: World Bank staff calculations based on data from SEFIN.

Figure 3.18. Scenario 1: Reduce Replacement Rate by 50 Percent

Source: World Bank staff calculations based on data from SEFIN.
per teacher. Given that our baseline projection suggests an STR of 23.6 in 2026, the effect of scenario 1 on STR is about one additional student per teacher by 2026.

Scenario 2 considers policies directed at reducing the starting wages of new hires, with a relatively low fiscal savings footprint in the short term. A 10 percent reduction on the starting wages of new hires can save up to $15.4 million (2021 prices) or 0.06 percent of GDP in the next five years (see figure 3.19). If instead of a 10 percent reduction, starting wages are reduced by 20 percent, the total savings go up to $28.9 million, which represents 0.11 percent of GDP. Conversely, a 5 percent cut in starting wages would entail savings that amount to $6.7 million (0.03 percent of GDP) in the next five years. Scenarios that cut starting wages are usually less effective to generate fiscal savings in the short term, because new hiring only starts representing a large part of the wage bill after several years and their salaries are lower than more experienced teachers (see figure 3.19). This is especially relevant for the case of Honduras’s teacher wage bill because the bulk of the current civil servants are expected to retire in the next 5 to 10 years.

Scenario 3 considers a policy reform that reduces the baseline net of inflation rate of salary increases, which can have a large fiscal impact. The policy scenario that reduces by half the rate at which wages are readjusted leads to fiscal savings that go up to US$105 million (2021 prices) in five years, which amounts to 0.42 percent of Honduras GDP (figure 3.20). The main reason behind these large savings is that instead of focusing only on new hiring (as in scenarios 1 and 2), such a policy targets all teachers. A policy that reduces wage readjustments by 25 percent is, in terms of savings, comparable to reducing replacement rates by half, as shown in
3.6. Strengthening civil service and management of the wage bill

Improving the capacity for planning and strategic decision-making regarding the management of the wage bill is crucial to maintaining sound public finances. Honduras has limited and uneven information on civil service and the wage bill. A key priority is therefore to improve the production and access to quality data on these issues that can support long-term decision-making and government’s resistance to economic crisis. Improving the production and the quality of human resources data and better integrating the multiple information management systems would enable the government to upgrade its wage bill analysis and to improve estimation of its costs to inform policy making. Basing decisions on broad and reliable data will also improve the tools to address wage negotiations with representatives from the different labor regimes and to respond to economic and natural crisis.

Additionally, in the short term, implementing the central wage negotiation mechanism is imperative to comply with the FRL. It is key to proceed with the publication and dissemination of the approved decree, which has been pending and is part of the agreement with the IMF. This PER recommends also complementing the existing decree with established multiannual global negotiation caps.
To control the growth of the wage bill and increase spending efficiency, it is essential to launch a comprehensive reform of the civil service. In parallel with the previous measures and with a medium-term perspective, the administration could consider carrying out the recommended road map for a broad but sequenced civil service reform covering the areas of (a) management of the civil service, (b) quality of human resources, (c) rationalization of the work force and its costs, and (d) transparency and integrity in the management of the civil service system.

Finally, it is essential to identify scenarios of possible savings through efficiency gains that enable the government to reduce waste and control the growth of the wage bill. This report has offered an initial group of scenarios for the education sector, estimated on the basis of the available information. This scenario analysis is illustrative and should be improved through the use of additional microdata and the consideration of other sectors that impose a considerable burden on the wage bill.

Notes


2. The available and missing data in Honduras records make the analysis of the wage bill challenging and limit the possibilities of modeling scenarios for policies that could drive efficiency gains. Some of the inconsistencies found when analyzing the microdata included the lack of data for an important part of the civil service when compared with the aggregate numbers. For the subset of public employees for which there are available microdata, there also are issues with some of the variables that were listed, such as the dates when civil servants were hired and when they retired.

3. The wage bill is defined as all wages and salaries measured on an accrual basis, including all cash and in-kind wages and salaries and severance payments, plus employers’ social benefits.

4. In 2019, owing to measures to contain spending on the wage bill, control of current transfers, and reduction in the acquisition of goods and services, the growth of current spending in the central administration was 6.8 percent—0.4 percentage points lower than the established goal of 7.2 percent. In April 2016, the authorities enacted the FRL to serve as an anchor for fiscal policy. The law places a cap on the size of the overall deficit (as a share of GDP) and imposes limits to the increase in current spending. It also introduces ambitious measures to control, quantify, and disseminate the size and impacts of the generous amount of tax expenditures.

5. Policy makers focus on keeping the wage bill levels under control, not only because of fiscal affordability but also because of the budget rigidity that these expenditures represent. The wage bill is among the components of public spending with the highest rigidity, and thereby governments usually cannot adjust the wage bill budget over a period of one to three years. Budget rigidity has become more relevant to policy makers because it prevents the government from adjusting the budget during periods of macroeconomic instability. As a consequence, more countries have relied on cutting public investment, which is a more flexible component of public spending but is more costly in the long run because reducing investment can stall economic growth. Source: Herrera and Olaberria, Budget Rigidity in Latin America and the Caribbean.

6. Herrera and Olaberria, Budget Rigidity in Latin America and the Caribbean.

7. While the wage bill on average was 12.5 percent of GDP during the past decade, capital expenditures remained on average below 6 percent of GDP.


10. Herrera and Olaberria, Budget Rigidity in Latin America and the Caribbean.

11. The payment data of employees under the civil service regime are administered by the DGSC in the Human Resources Administration System, which is integrated into the financial management system (SIAFI) administered by SEFIN, whereas the data of payments to teachers under their statute are administered by the Ministry of Education in the Teachers’ Human Resources Administration System and reported to the SEFIN through the Teachers Administration System, also integrated into SIAFI. SEFIN manages the System of Registration and Control of Public Servants with employment information of the central government, including deconcentrated and decentralized agencies. The DGSC manages data on personnel selection and changes reported by government institutions, for personnel under its competence. Retiree data are managed by pension institutions and there is no aggregate employment information from municipalities. All these systems work in parallel and have partial interconnection.

12. Professional regimes are established for primary and secondary teachers, doctors, nurses, dental surgeons, chemists, pharmacists, microbiologists, and social workers.

13. Lack of administrative autonomy leads to the DGSC’s not being able to make decisions directly or to implement them, as well as its inability to instruct other entities to implement them in turn.

14. J. Boyer, Gestión del servicio civil en Honduras desde una perspectiva jurídica (Lima: Banco Mundial, 2019); ASJ (Asociación para una Sociedad más Justa), Diagnóstico externo de la Dirección de Servicio Civil (Tegucigalpa: ASJ, 2018).

15. Deloitte, Implementación del Sistema de Clasificación y Valoración de Puestos en Instituciones Piloto de la Administración Pública (Tegucigalpa: Deloitte, 2018); Boyer, Gestión del servicio civil en Honduras desde una perspectiva jurídica.

16. Deloitte, Implementación del Sistema de Clasificación y Valoración de Puestos en Instituciones Piloto de la Administración Pública; ASJ, Diagnóstico externo de la Dirección de Servicio Civil.

17. Deloitte, Implementación del Sistema de Clasificación y Valoración de Puestos en Instituciones Piloto de la Administración Pública; Boyer, Gestión del servicio civil en Honduras desde una perspectiva jurídica.

18. Boyer, Gestión del servicio civil en Honduras desde una perspectiva jurídica; ASJ, Diagnóstico externo de la Dirección de Servicio Civil.


20. ASJ, Diagnóstico externo de la Dirección de Servicio Civil.


23. ASJ, Diagnóstico externo de la Dirección de Servicio Civil; Boyer, Gestión del servicio civil en Honduras desde una perspectiva jurídica.
24. In Honduras, only 52.7 percent of children are enrolled in preschool education compared to 67.8 percent in Latin America and the Caribbean; similarly, the secondary enrollment rate is only 44.0 percent, whereas the average for Latin America and the Caribbean is 71.3 percent. These indicators are even lower for the poor and vulnerable at 51.2 percent and 21.9 percent, respectively. The graduation rates of primary and secondary schools are also below the region's average.

25. Data retrieved from SEFIN can be found at https://www.sefin.gob.hn/ciclo-de-inversion-publica/.


27. Percentage differences in public sector education industry wages compared to private sector education wages (in local currency units) controlling for education, age, gender, and location.

28. The public sector wage comparison ratio is the ratio of the wages of the indexed occupations within the reference country to the global median for the same category. To control for differences in prices across nations, the administrative data in local currencies are converted and benchmarked in US$ using purchasing power parity conversion factors (household expenditure) to allow adequate comparisons. With such a methodology, this indicator provides a way of comparing the standards of living across countries and regions.

29. These numbers suggest that primary school teachers are in general better compensated than secondary school teachers in Honduras. There are no available data to compare this compensation with peer countries.

30. Disaggregated data at the level of individual teacher.

31. The *interinos* are teachers who entered the teaching career without a degree for the level at which they work and are in the process of professionalization. They are assigned to a temporary position while they acquire the corresponding degree.

32. Information on teachers’ years of service was available only in the first batch of data from 2007 to 2017. Because that variable was constant for the same employee over the years, we assumed that it registered the years of service in 2017, following the methodology adopted in the 2018 report on wage bill expenditures.

33. The projections of STRs have two components: (a) the number of teachers and (b) the number of students. To estimate the number of teachers, we used our microdata model. For estimating the number of students, we used a data set shared by the Ministry of Education that comprises the number of students enrolled in public schools in Honduras from 2015 to 2021. With such data, we calculated the average annual percent variation in the number of students (−1.6 percent) and used it to project the number of students in public schools in Honduras until 2026.
Appendix A: Reducing the Fiscal Deficit and Maintaining Fiscal Sustainability—Reform Measures

**Fiscal management.** In 2016, the government enacted the fiscal responsibility law (FRL) to strengthen public finances by (a) setting a 1 percentage point of GDP ceiling for the nonfinancial public sector (NFPS) deficit in 2019 and forward (deficit targets for the 2016–18 transition period were separately specified), (b) limiting the nominal growth of current spending to average GDP growth over the previous 10 years plus the projected inflation in the year ahead, and (c) limiting floating rate debt to 0.5 percent of GDP at the end of each fiscal year. The FRL formalized the medium-term fiscal framework (MTFF) as a critical part of the budget cycle and required a formal assessment by the Central Bank of Honduras (BCH) on the consistency of the MTFF with monetary and exchange rate policies. In addition, a new budget monitoring office, the Dirección General de Política Macro-Fiscal (DGPMF), was created to scrutinize fiscal indicators.

**Managing debt-related fiscal risk.** Honduras further anchored fiscal sustainability by creating the Fiscal Responsibility Unit (FRU) by developing a risk management framework for specific fiscal risks, and by quantifying risks. The government prepared and published the first Fiscal Risk Statement, which accompanied the 2020 budget bundle. The scope of the latest publication—attached to the 2021 draft budget law—was expanded. The country’s 2021 FRS is well developed, comprehensive, and complies with the legislation except in the case of risks from natural
Further progress, however, is needed to manage the country’s exposure within a more comprehensive perspective (for example, management of global risks, fiscal rules implementation), as well as the contingent liabilities linked to public-private partnerships (PPPs), the debt portfolio of NFPS entities, loan guarantees, municipalities, state-owned enterprises (SOEs)—in particular the energy sector—as well as natural hazards.

**Tax policy.** The government has made revenue mobilization efforts over the past five years without having to change statutory tax rates. It incorporated a tax code in 2017 aimed at simplifying tax collection, broadened the tax base by streamlining exemptions, made customs reforms (including a new operating manual to enhance the collection of import duties in gasoline and bulk freight), introduced electronic notifications of suspicious activity to taxpayers, and upgraded to a modern system based on timely tax refunds. The tax reform included a 3 percentage point increase in the value added tax rate (from 12 to 15 percent), higher fuel taxes, the establishment of a minimum income tax to strengthen tax compliance, and the elimination of some exemptions helped to strengthen the revenue side. Congress also eliminated the “most privileged regime” concession to special economic zones.

**Tax administration.** The tax administration has modernized, based on a sound governance framework, the professionalization of the public service, and robust integrity assurance mechanisms. Significant progress was achieved on the registered taxpayer base, voluntary compliance, the filing and payment of declarations, and accurate reporting in tax declarations. Further progress is needed on revenue management, accountability and transparency, risk management, the administrative review process, and dispute resolution to more fully conform to international good practices.

**Public debt management.** The government made progress on debt transparency. The medium-term debt strategy and financing plans are updated annually. The authorities have nearly completed drafting the content of the Debt Law (LOP) in accordance with the recent Debt Management Performance Assessment. Moreover, debt recording and payment processes are well defined and cover both the subnational level and SOEs. According to the Debt Reporting Heat Map, instrument, sectoral, and annual borrowing plan reporting remains partial. The government is working to further develop the domestic debt market, with longer maturities to be increasingly held by pension funds and other institutional investors and aiming to have a larger proportion of debt denominated in lempiras.

**Public financial management.** Progress in controlling public wage growth has been limited and is constrained by structural challenges, such as lack of a coherent legal framework for public employment, multiple special regimes, and a lack of a clear remuneration policy. Insufficient skills, poor information systems, and a lack of resources are compounding factors that provide room for fraud, leaks, and inefficient staffing, which adversely affect the ability to plan effectively and control expenditures. The statute of the Honduran civil service is not unified nor does it reach all institutions, so efforts are needed to implement a common salary policy, to streamline differences among regimes, to improve the criteria for hiring staff, and to consolidate the different
contracting modalities that currently are being used. The government has taken some first steps in this direction. In 2019, it approved a salary adjustment for public employees in the civil service regime, and in June 2020, it established a centralized mechanism for negotiating salaries to guide decisions on nominal wage increases in line with the FRL. In addition, to improve the framework and decision-making for PPPs, the government created a new unit in the Treasury supported by an interinstitutional council to improve the management of PPPs, to assess the convenience of procuring PPPs rather than traditional public investments, and to conduct technical feasibility and cost-benefit studies. The government has also submitted to Congress a new public procurement law that will modernize and strengthen the compliance process, which will increase transparency as public procurement contracts only have legal validity once they are published on the public purchases and contracting platform, Honducompras.

**Power sector.** Since the 2015 Systematic Country Diagnostic was done, the government has taken steps toward resolving Empresa Nacional de Energía Eléctrica’s (ENEE) financial position, including reducing its nontechnical losses, introducing a rightsizing program that reduced the workforce by 60 percent, adjusting quarterly tariffs based on a cost-recovery formula, and creating a new post of Secretary of Energy to support the implementation of the electricity sector’s reform. The government has been taking steps to reassess generation contracts that have not yet come into effect. Its reform agenda has been focusing on strengthening supervision of ENEE, reducing its losses, strengthening its governance and audits, and dividing up the company into three departments dealing with the generation, transmission, and distribution of electricity. Despite this, ENEE’s financial situation represents a key fiscal vulnerability in Honduras. Government subsidies further compound the effect of the sector on public finance. The financial eases that were designed to face the crisis (for example, a $600 million sovereign bond in June 2020) are merely bandages that will not cure the hemorrhage: an urgent implementation of the reform is needed.

**Monetary, exchange rate, and financial sector policies.** The government has taken steps toward modernizing its monetary policy framework with the aim of facilitating a transition toward inflation targeting. It has also adopted measures to make the financial system more resilient including a new securities market law, as well as introducing international financial reporting standards and enhancing forecasting capacities at the BCH. The new regulations for the interbank money market and foreign exchange market, approved in 2017, have contributed to bolstering the monetary transmission mechanism and supporting the de-dollarization of the economy (the crawling-band exchange rate regime continued to anchor monetary policy and enabled a steady depreciation of the lempira). In response to the pandemic, the BCH has cut the policy rate by 250 basis points from 5.50 percent in January 2020 to 3.00 percent in November 2020, suspended liquidity absorption operations, and reduced reserve requirements from 12 to 9 percent, among other measures.
Appendix B: Definition of Peer Countries

The Public Expenditure Review (PER) uses the same definition of peer countries as in the Honduras Systematic Country Diagnostic (SCD) to compare Honduras’s performance from the different perspectives. For the international benchmarking exercise of Honduras, three groups of countries are considered: regional peers represented by the Central American average (including the Dominican Republic), structural peers and aspirational peers. The criteria below were used to select the set of structural and aspirational peers using the Country Economic Memorandum (CEM) 2.0 Tool.

Structural peers

Under this classification, the tool identifies countries with similar economic and social or demographic performance as Honduras. The analysis relies on a proximity statistical method by using a defined set of variables. The set of variables selected for the period 2010–19 are as follows:

- Total population: To consider the size of the country as a constraint and thus include small countries in terms of population
- Percent of population between the ages of 15–64: To include countries where population is young, given the relevance of this as a labor factor endowment and to the growth model
- Tax revenues as percentage of gross domestic output: To include countries with high levels of tax revenues and little space to increase them
- Valued added manufacturing: To include economies where manufacturing is the relevant sector
- Human Capital Index: To consider quality of labor force in education and health attainment
- GDP per capita (PPP constant 2017 international $): To limit selection to countries that are lower middle-income
- Global Climate Risk Index 2000-19: To account for the level of exposure and vulnerability to extreme climate-related events

In addition, countries that are net hydrocarbon exporters were excluded. All indicators are weighted equally. The analysis suggests the following structural peer countries: El Salvador, Lao People’s Republic, Nicaragua, and Senegal.

Aspirational peers

This classification presents countries that possess similar structural conditions but have evolved and overperformed when compared with Honduras. Specifically, based on the set of variables, the tool identifies the countries that have achieved a remarkable progress in a specific target variable. For the period 2010–19, the target variables are annual GDP per capita growth and government effectiveness to capture countries that are structurally similar. For measuring government effectiveness in countries that have achieved high rates of productivity, the set of variables used are (in this order): Government Effectiveness, Rule of Law, and Voice and Accountability.

The analysis suggests the following aspirational peer countries: Benin, Cambodia, Dominican Republic, and the Philippines.
Appendix C: Public Revenues and Expenditures in Millions of Lempiras and as Percentage of GDP

**Figure C.1. NFPS Revenues**

Source: World Bank staff calculations based on data from SEFIN.

**Figure C.2. NFPS Expenditures**

Source: World Bank staff calculations based on data from SEFIN.

**Figure C.3. Overall and Primary Balance and Debt**

Source: Word Bank staff elaboration based on IMF estimates and MPO series.

**Figure C.4. Fiscal Measures in Response to COVID-19 and Overall Fiscal Balance, 2020**

Source: Word Bank staff elaboration based on IMF estimates and MPO series.

Note: Fiscal package includes liquidity support and above the line measures.
Table C.1. Fiscal account of the NFPS, percent of GDP

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<td>8.1</td>
<td>8.1</td>
<td>8.3</td>
<td>8.2</td>
<td>8.7</td>
<td>9.2</td>
<td>10.0</td>
</tr>
<tr>
<td>Interest paid</td>
<td>0.9</td>
<td>1.1</td>
<td>1.3</td>
<td>2.1</td>
<td>2.3</td>
<td>2.3</td>
<td>2.7</td>
<td>2.2</td>
<td>2.4</td>
<td>2.3</td>
<td>2.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Current transfers</td>
<td>3.5</td>
<td>3.7</td>
<td>3.9</td>
<td>4.3</td>
<td>4.5</td>
<td>4.2</td>
<td>4.5</td>
<td>4.3</td>
<td>3.9</td>
<td>4.0</td>
<td>4.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Other current expenses</td>
<td>0.6</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>5.3</td>
<td>5.6</td>
<td>5.5</td>
<td>6.4</td>
<td>5.9</td>
<td>5.5</td>
<td>5.9</td>
<td>6.3</td>
<td>6.4</td>
<td>5.5</td>
<td>4.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Real investment</td>
<td>4.7</td>
<td>4.4</td>
<td>3.7</td>
<td>5.1</td>
<td>3.8</td>
<td>3.8</td>
<td>3.4</td>
<td>4.5</td>
<td>4.4</td>
<td>3.8</td>
<td>3.2</td>
<td>5.5</td>
</tr>
<tr>
<td>Inventory variation</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Other capital</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>0.3</td>
<td>0.0</td>
<td>0.4</td>
<td>0.3</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital transfers</td>
<td>0.2</td>
<td>0.8</td>
<td>1.2</td>
<td>0.9</td>
<td>1.8</td>
<td>1.6</td>
<td>2.2</td>
<td>1.6</td>
<td>2.0</td>
<td>1.7</td>
<td>1.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>-3.0</td>
<td>-3.2</td>
<td>-4.4</td>
<td>-7.5</td>
<td>-3.9</td>
<td>-0.9</td>
<td>-0.5</td>
<td>-0.8</td>
<td>-0.9</td>
<td>-0.9</td>
<td>-5.5</td>
<td>-5.8</td>
</tr>
</tbody>
</table>

Source: World Bank staff calculations and projections (as of Q1 2022) based on SEFIN data.
Appendix D: Indicators of Public Debt under Alternative Scenarios, 2021−31

Figure D.1. PV of debt-to-GDP ratio

Figure D.2. PV of debt-to-revenue ratio

Figure D.3. Debt service-to-revenue ratio

Source: Joint World Bank-IMF Debt Sustainability Analysis (2021), based on the data from SEFIN.
## Appendix E: Key Responsibilities of SEFIN Entities in Managing Fiscal Risks

<table>
<thead>
<tr>
<th>Entities</th>
<th>Responsibilities</th>
<th>Policy instruments</th>
<th>Risk disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRU</td>
<td>Identifies and quantifies risks; formulates mitigation plans</td>
<td>FRS (specific fiscal risks) and PPP report</td>
<td></td>
</tr>
<tr>
<td>DGPMF</td>
<td>Elaborates MMFMP; monitors compliance with the fiscal rule.</td>
<td>MT fiscal framework</td>
<td>Quantitative macro-fiscal sensitivity</td>
</tr>
<tr>
<td>DGP</td>
<td>Centralizes budget programming; monitors budget execution for all public sector entities.</td>
<td>MT and annual budget</td>
<td></td>
</tr>
<tr>
<td>DGIP</td>
<td>Defines MT and annual investment programs for all entities; follows project execution</td>
<td>Multiyear public investment plan</td>
<td></td>
</tr>
<tr>
<td>DGCP</td>
<td>Formulates public debt policy; evaluates the creditworthiness of applicants for loan guarantees</td>
<td>MT public debt policy, and debt strategy</td>
<td>Public debt risks and long-term dDSA</td>
</tr>
<tr>
<td>DGID</td>
<td>Assesses the financial performance of decentralized entities quarterly</td>
<td></td>
<td>Financial management report on decentralized entities</td>
</tr>
<tr>
<td>CGR</td>
<td>Implements the SIAFI; submits the Financial Consolidation Report to National Congress</td>
<td></td>
<td>Balance sheet</td>
</tr>
</tbody>
</table>


Note: CGR = General Accounting Office of the Republic; DGP = General Directorate of Budget; DGCP = General Directorate for Public Credit; DGID = General Directorate for Decentralized Institutions; DGIP = General Directorate for Decentralized Institutions; DGPMF = General Directorate of Micro fiscal Policies; DSA = debt sustainability analysis; FRS = fiscal risk statement; FRU = financial risk unit; MMFMP = medium-term macro-fiscal framework; MT = medium term; PPP = public-private partnership; SIAFI = integrated financial management system;
# Appendix F: Responsibilities of the Main Entities Involved in PPP

<table>
<thead>
<tr>
<th>Entities</th>
<th>Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPP Superior Council</td>
<td>Designs policies and strategies and formulates programs, plans and projects to be financed by PPPs.</td>
</tr>
<tr>
<td>Contracting agency</td>
<td>Proposes projects to UTEP-APP and submits cost-benefit analyses and economic models, signs the contract with the private sector; and monitors the quality of the services provided together with UTEP-APP.</td>
</tr>
<tr>
<td>UTEP-APP (ex-COALIANZA)</td>
<td>Receives proposals from contracting agencies; conducts feasibility studies; proposes to SEFIN the inclusion of a PPP in the SNP and sends the results of feasibility studies; approves contracts after authorization by the Council of Ministers; implements and manages the PPP contracts; and promotes PPPs.</td>
</tr>
<tr>
<td>SEFIN, incl. FRU</td>
<td>Carries out risk analysis of the proposed project to determine its feasibility as a PPP; coordinates the structuring process with UTEP-APP; assesses the main fiscal implications of all PPP projects; develops action plans in case any fiscal contingencies are triggered; and warns the executive branch about PPP limits.</td>
</tr>
<tr>
<td>Executive</td>
<td>Sets legal limits for PPPs; authorizes PPP contracts; and sends the contract to Congress for ratification (and for final approval in special cases)</td>
</tr>
<tr>
<td>National Congress</td>
<td>Ratifies the contract through legislative decree (and approves contracts in special cases).</td>
</tr>
<tr>
<td>SAPP</td>
<td>Manages independent ex-post evaluations of PPP contracts</td>
</tr>
</tbody>
</table>


Note: COALIANZA = Commission for the Promotion of Public-Private Partnerships; FRU = fiscal risk unit; PPP = public-private enterprise; SAPP = PPP superintendence; SEFIN = Ministry of Finance; SNP = national public investment system; UTEP-APP = specialized technical unit for PPP projects.
## Appendix G: Fiscal Risk Matrix for Liabilities

<table>
<thead>
<tr>
<th>Explicit liabilities (Legal obligation—no choice)</th>
<th>Direct liabilities</th>
<th>Indirect liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Foreign and domestic sovereign debt</td>
<td></td>
<td>Guarantees for borrowing and obligations of subnational governments and SOEs</td>
</tr>
<tr>
<td>- Budget expenditures—in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions.)</td>
<td></td>
<td>Guarantees for trade and exchange rate risks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Guarantees for (PPPs)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unexpected compensation in legal cases related to disparate claims</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reconstruction of public assets</td>
</tr>
<tr>
<td>Implicit liabilities (Expectations—political decision)</td>
<td>Future public pensions, if not required by law.</td>
<td>Defaults of subnational governments and SOEs on nonguaranteed debt and other obligations</td>
</tr>
<tr>
<td></td>
<td>Social security schemes, if not required by law.</td>
<td>Liability clean-up in entities being privatized</td>
</tr>
<tr>
<td></td>
<td>Future health care financing, if not required by law.</td>
<td>Bank failures (support beyond state insurance)</td>
</tr>
<tr>
<td></td>
<td>Future recurrent cost of public investments.</td>
<td>Failures of nonguaranteed pension funds, or other social security funds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Environmental recovery, natural hazard relief</td>
</tr>
</tbody>
</table>


Note: PPP = public-private partnership; SOE = state-owned enterprise.
Appendix H: Road Map for Civil Service Reform

This appendix describes the measures proposed as part of a road map for civil service reform in Honduras. These measures

- will have positive effects on the governing or leadership capacity of the civil service and on public employment in general;
- will address the challenges of improving the personnel profile and technical quality of public servants and guarantee their suitability for the assigned responsibilities;
- will seek to rationalize, balance, and ensure the sustainability of the payroll and its costs; and
- will create an environment more conducive to developing an adequate civil service and a system of professionalization of public employment with a sense of accountability.

Each topic includes a table of proposed measures, classifying them according to the possibility of (a) short-term adoption, (b) technical complexity, (c) level of difficulty in achieving the necessary political consensus and the sources of support needed for adoption, and (d) whether the measure helps improve and organize the current situation as a first step toward a more structural reform, or whether it would directly affect the desired transformation.

Civil service management

The civil service is facing a series of challenges linked to problems such as: (a) a patchwork of norms on human resources management; (b) a disparity of capacities and disarray in the organizational structures responsible for the management of different regimes; (c) redundancy of functions; (d) limited access to decision-making bodies in the public administration on the part of the General Directorate of the Civil Service (DGSC); (e) a lack of management instruments—for example position inventory, appropriate information systems, and selection models—to govern the civil service. Taken as a whole, this situation affects the ability to guide the proper application of the regulations.

Recommended measures

Redefine the DGSC’s location. To strengthen the governing capacity of the DGSC, a greater degree of technical, administrative, financial, and political autonomy is recommended. It is therefore proposed to transform it into a decentralized public body, closely articulated with the Ministry of Finance, with the goal of tightening mechanisms for coordination with treasury affairs.

Strengthen the DGSC’s technical and operating capacity. Give the DGSC sufficient resources to strengthen its technical and operating capacity, thus allowing it to implement the recommended measures (example, job profile audit and support for human resources office). The team selection process must be professional and transparent based on a previously defined plan of action and profiles to leverage the technical legitimacy of the DGCS, especially in the face of political changes. This way, even if the head of DGCS is appointed on party lines, the rest of the organization can be adequately shielded to keep it from becoming politicized.
**Strengthen the human resource offices.** Create a line of work aimed at strengthening the human resources offices so they can be used to improve other career functions (e.g., generation and analysis of public servant information, personnel file management, training, selection and professionalization of servants, individual career development planning, and organizational needs planning, among others).

**Create an institutional census and audit program.** Audit and clearly define all job positions to ensure they are consistent with the official description. Support the audit program by generating relevant information for strategic management of the civil service, gathering basic personnel information in the form of a census to better manage development, growth, and forecasting of needs.

**Improve records and information systems.** It is essential that the civil service be governed based on up-to-date information with which to evaluate public administrative personnel. Integration of payroll information from the different bylaws must also continue. This information must be designed to provide detailed records for remunerations as well career planning, the application of professional measures, prediction of needs, the possibility of proposing voluntary retirement programs, and other factors. In addition, the information management systems must
be improved so they include all employment information and records, with security protocols and management procedures that ensure consistency, timeliness and a proper use of data to improve management of the civil service as well as to make adequate projections and management of current expenses.

**Harmonize regimes, undertake regulatory adjustments, and pass a new civil service law.** Developing and approving regulations with sufficient force to be applied by all national public administrative entities and decentralized entities, as well as other organizational forms, may be too technically and politically complex. Therefore, gradually standardizing regulations that are not law or making specific changes to those regulations, may allow in the medium term to reduce the number of special regimes. Thus, it will help manage job positions, remunerations, training, and performance. Once this is achieved, it will be less complicated to approve and implement a new civil service law that addresses the peculiarities stemming from the institutional heterogeneity of public administration and its extremely diverse functions. At the same time, it will maintain sufficient centrality and homogeneity to develop consistent human resources and salary management policies.

**Human resources quality**

Human resources quality is understood as suitability for job positions. Several recent studies have identified the following challenges for Honduras: (a) insufficient technical or professional training compared with requirements; (b) low level of specialized training in some public agencies’ personnel management units; (c) outdated, incomplete, or nonexistent job profiles; (d) gaps between public servants’ capacities and training and what the mission actually demands of them; (e) absence of career paths or trajectories despite being established in the Civil Service Act; (f) personnel selection processes that, generally speaking, do not guarantee the suitability of the hires; and (g) unsuccessful implementation of performance evaluations.

**Recommended measures**

**Develop and approve the job position manual.** This measure seeks to provide an instrument that will help establish and unify criteria to strengthen the civil service and all contract types in general. It is the foundation for training, selection, career path, and even job and salary standardization and validation actions. The instruments to be developed include protocols for the job identification process in all institutions, a review of information on job positions, the description of job functions, details on the position’s respective mission, and the requirements for the position. The guide shall be accompanied by the corresponding forms to ensure uniformity when preparing these manuals. For such purpose, it may be helpful to review good practice in other Latin American countries to reduce technical complexity when preparing the guide. Implementation must be accompanied by processes for the strengthening of the DGSC so that it can provide advice to ministries on the process of preparation and updating.

**Identify competency gaps and develop training programs to regularize competencies for job positions.** This measure involves analyzing the gap existing between the competencies required
The analysis should identify recurring competency or training gaps in the same job family so that they are the first to be addressed generally, thus achieving the biggest possible positive effect. The training program will then include a section on activities to close gaps for job families, followed by gap closure for standard positions, and finally, depending on how critical the position is, in certain cases a part designed for each public servant. It is recommended to perform this last stage in the training after the first two have been completed and the “Early Retirement Cost vs. Voluntary Retirement Compensation Study,” as described subsequently in this appendix, has been prepared. Positions to be prioritized are those tied to budget programming and execution, policy formulato rs, internal control personnel who will help ensure a continuous monitoring mechanism, and the personnel in charge of human resources who will be responsible for implementing the process over the long term. Because these functions are present in all entities and are relatively standard, they can be addressed using a general, and central approach. They are also critical in ensuring the effectiveness of the policies developed by other areas. As such, professionalizing the career in these positions will help create a kind of platform for the effectiveness of the government as a whole.

**Select certain career paths and allow for the civil service to implement and monitor them.** This measure involves selecting key jobs to start the development of career paths. Prioritize job families tied to public spending, internal control, and human resources management, as noted

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**Table H.2. Improvements to Human Resources Quality**

<table>
<thead>
<tr>
<th>Recommended measures</th>
<th>Start term</th>
<th>Technical complexity</th>
<th>Political complexity</th>
<th>Impact on CS</th>
<th>Reform type</th>
<th>Political support required</th>
<th>Positive effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Develop and approve the job positions manual</td>
<td>Short</td>
<td>Medium</td>
<td>Low</td>
<td>Medium</td>
<td>Organize</td>
<td>Executive branch</td>
<td>Capacities for the position</td>
</tr>
<tr>
<td>Verify, identify gaps, and implement training programs for regularization of positions</td>
<td>Short</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Organize</td>
<td>Executive branch</td>
<td>Capacities for the position</td>
</tr>
<tr>
<td>Select certain career paths and create controlled CS implementation so DGSC can monitor.</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
<td>Transform</td>
<td>Congress</td>
<td>Capacities for the position</td>
</tr>
<tr>
<td>Improve recruitment and selection process for all types of contracts</td>
<td>Long</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
<td>Transform</td>
<td>Executive branch</td>
<td>Capacities for the position</td>
</tr>
<tr>
<td>Improve performance evaluation instruments and practices for all types of contracts</td>
<td>Long</td>
<td>Low</td>
<td>High</td>
<td>Medium</td>
<td>Transform</td>
<td>Executive branch</td>
<td>Capacities for the position</td>
</tr>
</tbody>
</table>

Note: CS = civil service; DGSC = Directorate General of Civil Service.

for a position and those the public servant currently has. The analysis should identify recurring competency or training gaps in the same job family so that they are the first to be addressed generally, thus achieving the biggest possible positive effect. The training program will then include a section on activities to close gaps for job families, followed by gap closure for standard positions, and finally, depending on how critical the position is, in certain cases a part designed for each public servant. It is recommended to perform this last stage in the training after the first two have been completed and the “Early Retirement Cost vs. Voluntary Retirement Compensation Study,” as described subsequently in this appendix, has been prepared. Positions to be prioritized are those tied to budget programming and execution, policy formulato rs, internal control personnel who will help ensure a continuous monitoring mechanism, and the personnel in charge of human resources who will be responsible for implementing the process over the long term. Because these functions are present in all entities and are relatively standard, they can be addressed using a general, and central approach. They are also critical in ensuring the effectiveness of the policies developed by other areas. As such, professionalizing the career in these positions will help create a kind of platform for the effectiveness of the government as a whole.

**Select certain career paths and allow for the civil service to implement and monitor them.** This measure involves selecting key jobs to start the development of career paths. Prioritize job families tied to public spending, internal control, and human resources management, as noted
previously, as well as certain functional areas that are aligned with the government’s priorities to foster a better political rapport regarding the reform.

**Improve recruitment and selection.** Good practice must be incorporated into recruitment and selection, including (a) the previous identification of vacant positions, (b) open and transparent calls based on the job profile described in the position map, (c) implementation of transparent selection processes with evidence that allows for the objective and subjective evaluation of the candidates for the position, and (d) performance of an induction process into the position and the organization. In these processes, those in charge of recruitment and selection must have the documents and competencies necessary to carry out the process. This means strengthening the recruitment personnel from the human resources offices of the DGSC, ministries, and other public entities. Start improving recruitment and selection for positions in job families where “career paths” are being developed.

**Improve performance evaluation instruments and practices.** Using the information from the position maps, begin to test the performance evaluation instruments for jobs with identical, low-complexity competencies and responsibilities, such as administrative positions. Additionally, a pilot could be performed in functional positions within the ministries, specifically those from the prioritized career paths. This measure is highly complex, given that if communication is not handled well, evaluations are often perceived by staff members as a step toward their terminations.

**Rationalization of payroll and its costs**
One of the key challenges faced by Honduran public finances is to guarantee better control over the total payroll costs for public officials. There are multiple problems tied to this issue: (a) high degree of heterogeneity in salaries; (b) highly discretionary salaries defined without objective criteria; and (c) salaries that differ drastically from current market values. This situation, along with the absence of or failure to apply other necessary principles and rules in operating the civil service, leads to clientelism, limited meritocracy, and harm to the performance of the entire public apparatus.\(^8\)

The selective, discretionary increase of salaries without clear, objective principles, the creation of collateral benefits, and exceptions and salary perks such as teachers’ exemption from paying taxes and collective bargaining, creates a deficit in the payment of remunerations and has increased the budget allocated to payroll.\(^9\)

**Recommended measures**
**Conduct a study on early retirement cost versus voluntary withdrawal compensation.** Comparing the cost of implementing an early retirement program with that of a voluntary withdrawal compensation program, since both mechanisms are effective in reducing public spending, and creating space for the renewal of positions with higher profiles should help implement strategies to stop the flight of productive, specialized employees who must be provided with better working
conditions. Early retirement may be a more objective alternative with a lower long-term effect, since senior citizens who previously worked as public officials will receive a constant income that will decrease their possibility of falling below the threshold of monetary poverty or extreme poverty. However, given that there has been a lack of homogeneity in the different entities’ development, the most politically and socially viable option must be identified case-by-case.

Develop a salary equivalent map between the different types of contracts. This measure involves the prospective modeling of salaries based on the requirements of the government, its organizations, and the job market. For Honduras, given that internal salary consistency has completely disappeared, job nodes or clusters need to be identified between contract regimes with similar salary ranges, they must be compared, and they must be progressively organized based on the complexity of the positions comprising each node. This analysis of salary distribution in the public administration will not only help determine whether the job levels are consistent with the job functions, but it will also compare them with the job market and gradually reduce outliers. This measure will also be useful during decentralized collective bargaining by providing parameters to apply in negotiations by entity or by contract type.

Develop and approve collective bargaining legislation (centralized, cap-based, with multiannual forecasts). The decree approved by the Cabinet of Ministers in 2020 (PCM 058-2020)
has yet to be enacted; it should be reinforced by including rules for the multiannual definition of overall negotiation caps (potentially negotiable fiscal resources) and adhering to rules to distribute fiscal resources in the budget among the entities that negotiate in each fiscal year. To this end, rules could be developed on (a) how to define which workers’ organizations can take part in the salary negotiations during each fiscal year; (b) how caps could be included on salary negotiation amounts consistent with the salary policy and salary equivalent. Concepts such as salary bands existing in the job market and salary variance forecasts should be consistent or should be included in the salary policy. As a general rule, it is appropriate to conduct central salary negotiations while applying decentralized measures for working conditions that are typically more relevant by activity or entity type.

**Salary policy that includes spaces for negotiation with workers’ organizations, placing caps on them.** This measure would be one of the last to be undertaken in the civil service reform and should be conditional upon progress in the previous recommendations (for example, standard job profiles, salary bands or ranges, performance evaluation methods, career paths and so forth) to consolidate a long-term public policy on public servant salaries. The salary policy must aim for internal salary consistency with similar levels of responsibility and specialization, and use market conditions as a reference point. To properly design and implement this measure, a transition plan is key to gradually apply the salary policy.

**Transparency and integrity in civil service management**

The problems of transparency and integrity in the public sector workforce are rooted in many of the situations described previously. Of particular note are: (a) the degree of discretion involved selecting and retaining public officials; (b) the absence of a standard definition of entities’ requirements for each position to allow for proper recruitment; (c) the lack of information on job inventories and the selection in general; (d) institutional weakness of entities responsible for governing the civil service (DGSC and the Technical Secretariat for the Municipal Administrative Career; SETCAM) and their distance from the centers of power; and (e) the prevalence of negotiations with workers that, on the government’s side, lack any basis in technical aspects. All of this creates an environment ripe for clientelism in public entities, which lack suitable personnel, lack

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**Table H.4. Improved Integrity**

<table>
<thead>
<tr>
<th>Recommended measures</th>
<th>Start term</th>
<th>Technical complexity</th>
<th>Political complexity</th>
<th>Impact on CS</th>
<th>Reform type</th>
<th>Political support required</th>
<th>Positive effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengthen transparency mechanisms in HR management to reduce political manipulation</td>
<td>Short</td>
<td>Low</td>
<td>Very high</td>
<td>Medium</td>
<td>Organize</td>
<td>Executive branch</td>
<td>Integrity</td>
</tr>
</tbody>
</table>

Note: CS = civil service.
evaluation and training adapted to an organization’s actual needs, and often suffer from salaries that are out of touch with the market.

**Recommended measures**

Strengthen transparency in human resources management to reduce political manipulation. To incorporate more suitable personnel, selection and internal mobility must be based on merit and be transparent. Human resource management must apply measures such as public notification for exams, public disclosure of the exam results, and evaluation systems based on knowledge and abilities as well as records available inside public organizations, whether from the DGSC or human resources offices (for example, police records, personnel files and so forth). Even for appointed positions in which the reasons for selection have more to do with political trust, a predefined job profile with transparency should be used to ensure the appointee’s qualifications.

A website should be developed with aggregate data (indicators) on (a) compliance with the public employment rules for each contract type, (b) individual information on those who hold decision-making positions, (c) public payrolls with information on who holds a position, (d) the contract type through which they were hired, and (e) the contract amount and term, as applicable. Information on selection exams and processes should be centralized to facilitate auditing. Finally, the obligation to keep this information up-to-date should have legal and administrative consequences for political and administrative authorities of each entity in case of failure to do so. In the interest of transparency, the data confidentiality criteria to be applied should be previously defined and restrictively interpreted.

**Notes**

1. Because of the COVID-19 crisis, the FRL’s escape clause was activated and the 2020 and projected 2021/2022 deficits exceeded the 1 percent target.


3. From the tax administration diagnostics assessment tool (TADAT), the International Monetary Fund, and the World Bank Group, 2020.


Chapter 2
Trucks and heavy machinery clearing the land for the construction of a Solar Energy PV Plant at Choluteca, Honduras
Photo by Francisco Javier Ramos Rosellon
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Chapter 1
Street scene in the colourful town of Copan Ruinas, near the Copan archaeological site, Honduras, Central America
Photo by Kumar Sriskandan
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Image ID: T5FTT7

Chapter 3
Main paved road, Departament of Comayagua, Honduras
Photo by J. Enrique Molina
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