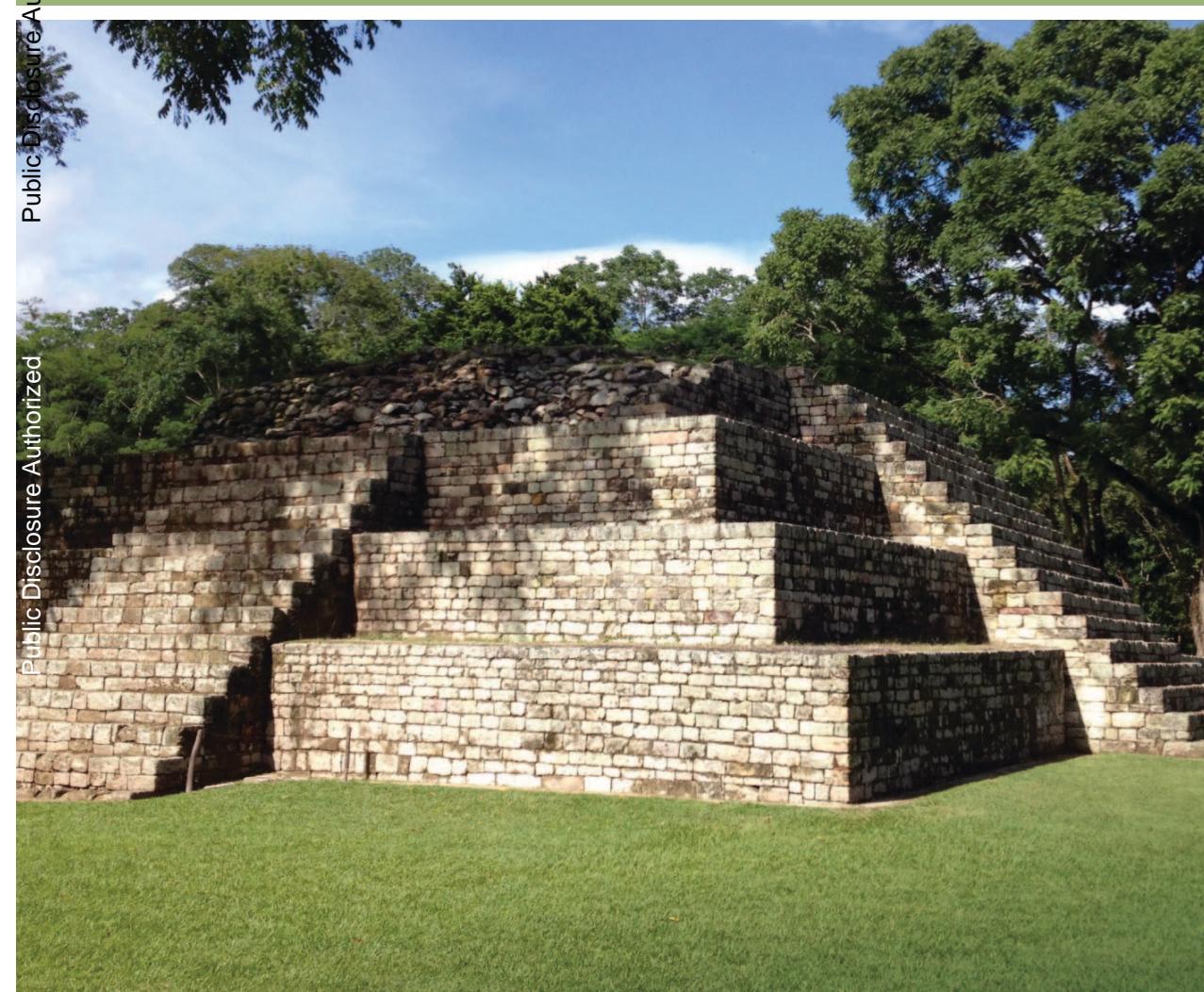


Honduras

Unlocking Economic Potential for Greater Opportunities

Systematic Country Diagnostic



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Honduras

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Chapter 1

Overview

Honduras is Central America's second-largest country with a population of more than 8 million and a land area of about 112,000 square kilometers. It has coastlines on both the Caribbean Sea, including the three Bay Islands, and the Pacific Ocean via the Gulf of Fonseca. Its inland territory is largely mountainous, with plains along the coast, and its rain forests, cloud forests, savannas, pine forests and the Mesoamerican Barrier Reef System boast a wealth of biodiversity. The country's two largest cities, Tegucigalpa and San Pedro Sula, are home to almost a quarter of its population, yet approximately half of the population lives in rural areas, where most are engaged in semi-subsistence agriculture.

The 20th century witnessed a profound economic transformation and modernization in Honduras. While agriculture continues to play an important role in gross domestic product (GDP), the manufacturing sector, driven by the product-assembly *maquila* industry, has become increasingly important. During the first part of the twentieth century, Honduras' exports centered mostly on bananas. In pursuit of a diversified and modern productive structure, the country invested in infrastructure and promoted credit markets to the primary sector in the mid-twentieth century (Eraque 2004). In the 1960s, the *Central American Common Market* was created to promote industrial production and further develop this sector. These policies resulted in a more diversified export structure. By the end of the 1960's, other commodities such as beef, cotton and sugar had become important players, while the share of bananas in total exports halved. Moreover, exports of industrial products to other countries within the region increased. With the creation of its first free trade zone in Puerto Cortés in the late 1970s and an export processing zone in the late 1980s, the country continued to implement policies to

support diversification. Trade liberalization policies were furthered with the integration to the World Trade Organization in the 1990s and, in the 2000's, when the country joined a free trade agreement between Central American countries and US (the *CAFTA-DR*).

Honduras possesses multiple strengths with the potential to form a base to propel the country towards faster growth and shared prosperity:

- First, its strategic location places Honduras as a potential investment destination. Indeed, the country has relatively high levels of Foreign Direct Investment (about 6 percent of GDP) flowing into fast-growing sectors including telecommunications, manufacturing, and financial intermediation. Honduras' location is also helped by the connectivity provided by its deep water port in the Caribbean Coast (Puerto Cortés) which has good access to US ports in the Caribbean Gulf and the East Coast. Puerto Cortes was also part of the first wave of ports included in the Secure Freight Initiative by which US officials can inspect the merchandise before departing the port towards the US.
- Second, the country's industrial base can support an expansion of the tradable sector. At about 20 percent of GDP, the manufacturing sector is relatively large compared to countries in Latin America and the Caribbean (LAC) and other middle-income countries, and given the country's small size, this expansion could have plenty of benefits due to economies of scale or the possibility of specialization. Although the *maquila* model (mainly concentrated in textiles) still plays an important role, the country has been making efforts to diversify to other areas including machinery and electrical devices.
- Third, the Honduran economy has the second largest trade-to-GDP ratio in LAC and its

efforts to diversify exports in the last decades not only have been successful in increasing the number of exported goods and destination markets, but also have developed internal competencies in the management of external trade, a valuable platform from which to further grow the country's presence in international markets.

- Fourth, with a young and growing population, Honduras has the opportunity to harness a demographic dividend. With about a third of its population between the ages of 10 and 24 and population growth rates declining, Honduras is in the early stages of the demographic transition and therefore in position to benefit from a demographic dividend.

And yet, despite the potential associated with its strengths, and the modernization efforts that transformed Honduras in the early 20th century, the country has the third lowest per capita income in LAC and is among the poorest countries in the Western Hemisphere. Nearly one in five Hondurans lives on less than US\$1.90 per day, the second highest rate in LAC. According to official poverty lines, in 2013 almost 65 percent of Honduran households lived in poverty and 43 percent lived in extreme poverty, including two out of three rural Hondurans. Nearly 80 percent of Hondurans younger than 15 live in impoverished households and approximately one in four is undernourished, with negative implications for learning abilities and future earning capacity. Even when there have been periods of poverty reduction, shocks have periodically erased gains. For instance, following a political and economic crisis in 2009, poverty rates increased for three consecutive years; by 2013 poverty rates had returned to the levels seen a decade earlier. In other words, there are forces at work that may result in poverty continuing to future generations unless an ambitious development plan is implemented.

While already behind standard comparators in 1960, the income gap between Honduras and the world has widened. In 1960 Honduras per capita income (in current US\$ terms) represented

150 percent of the low- and middle-income countries (LMICs) per capita income, 13.5 percent of the high-income countries (HICs) per capita income and 5.6 percent of the US per capita income. In 2014, when per capita was about US\$2,300 (the third lowest in LAC), these same indicators had fallen to 86 percent, 6.2 percent and 4.3 percent respectively. In other words, Honduras has been diverging from these three comparators for more than half a century, a reflection of the country's sustained lower growth rates. Indeed over the 1960–2014 period, Honduras average per capita income growth (1.2 percent) was well below the one observed in the LMIC group (3.1 percent), the HIC group (2.3 percent), and the US (2.0 percent).

Honduras' persistent poverty is the result of long-term low per capita growth and high inequality, perpetuated by the country's high vulnerability to shocks.

- First, over the past 40 years the country has experienced modest growth rates marked by considerable volatility. This growth, however, has not been sufficient to keep pace with its rapid population growth, resulting in a widening per capita income gap between Honduras and the world. Its low average growth masks high volatility: over 1960–2014, the standard deviation of growth in Honduras was 44 percent, 83 percent and 52 percent larger than that of Low and Middle Income Countries, High Income Countries, and the US. Low growth has limited the ability of the private sector to generate jobs, resulting in weak employment outcomes. For instance, Honduras has one of the lowest labor force participation rates in LAC, a small formal sector (accounting for only 20 percent of jobs) and the highest self-employment rate in Central America.
- Second, high levels of inequality have weakened the ability for growth to reduce poverty by limiting the extent to which a large segment of the population is able to fully access physical and human capital. Making comparisons for earlier periods is difficult due to data limitations, but existing proxies suggest that the

country's inequality has historic roots. In 1925, for example, only 29 percent of Hondurans 10 years old and above were literate. This compares to 36 percent in Mexico, 40 percent in Colombia, and 64 percent in Costa Rica. For LAC countries for which comparable data exist, only Guatemala, at 15 percent, had lower literacy rates. In the early-1990s, the country's Gini coefficient (0.56) was already among the highest in LAC after Brazil (0.59). With a Gini of 0.54 in 2013, Honduras has the second most inequitable income distribution in LAC which means that growth has not been able to lift many Hondurans out of poverty. While LAC has been moving towards becoming a middle class region, Honduras' middle class has not grown over the past decade and remains among the smallest in the region.

- Third, a large share of the population is vulnerable and exposed to regular shocks—both large and small—which has exacerbated poverty by destroying or slowing asset accumulation. For example, in 1998, Hurricane Mitch caused 11,000–18,000 fatalities and destroyed 70 percent of the country's crops and 70 percent of the nation's transport infrastructure, with an economic damage estimated at around 81 percent of GDP. Beyond natural hazards, “smaller” shocks—such as periodic floods, droughts, and outbreaks of blight including the “coffee rust”—have damaged agricultural production and hurt the poor. As a small open economy, Honduras is also exposed to terms of trade shocks which at times have disrupted periods of economic expansion. Evidence suggests the poorest households struggle the most with shocks, as the effects on assets last longer and are felt more acutely relative to wealthier groups.

This Systematic Country Diagnostic (SCD) explores the drivers of these development outcomes in Honduras, and reflects on the policy priorities that should underlie a development strategy focused on eradicating poverty and boosting shared prosperity. After identifying a

number of critical factors affecting the country's development outcomes, the SCD concludes that there is a need for a comprehensive agenda that tackles simultaneously the problems that have kept the country in a low development equilibrium for many decades, as well as emerging challenges that have the potential not only to prevent progress but also worsen the current situation. The SCD also argues that the policy agenda needs to be ambitious and move away from marginal interventions in order to move Honduras from a situation where its economic potentials are just potentials to another where they become actuals.

1.1 Crime and Emigration: The Emergence of Two Cycles Locking in Low Growth

Honduras' history of low and volatile economic growth and high inequality have created the conditions for the emergence of two mutually reinforcing cycles: (a) a high crime-low growth cycle; and (b) an emigration/remittance flows-low growth cycle. Over the last 15 years these cycles have shaped the challenges faced by Honduras and have continued to impact the country's growth prospects.

Honduras has one of the highest levels of crime and violence in the world, undermining growth and stifling economic opportunity (figure 1.1). With 67 murders per 100,000 inhabitants in 2014, Honduras' homicide rates are among the highest in the world. Honduras has been strategically important to the drug trade since the 1970s, but in the last 15 years the country has witnessed an increase in gang activity and a rise in violent crimes such as extortion and kidnapping.¹ Young men are particularly vulnerable to crime, both as victims and perpetrators. The cost of crime in Honduras is estimated to have reached a staggering 10 percent of GDP (US\$900 million) per year, and the health costs alone are estimated at 1.3 percent of GDP (World Bank 2011a). Security costs slash an

FIGURE 1.1 A Vicious Cycle between Crime and Violence and Low Growth

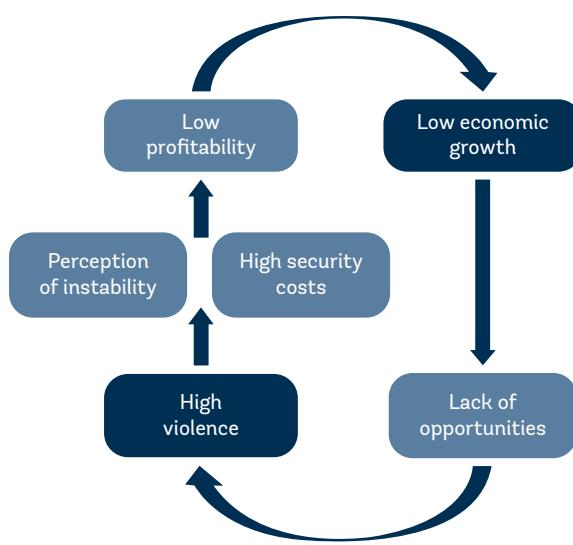
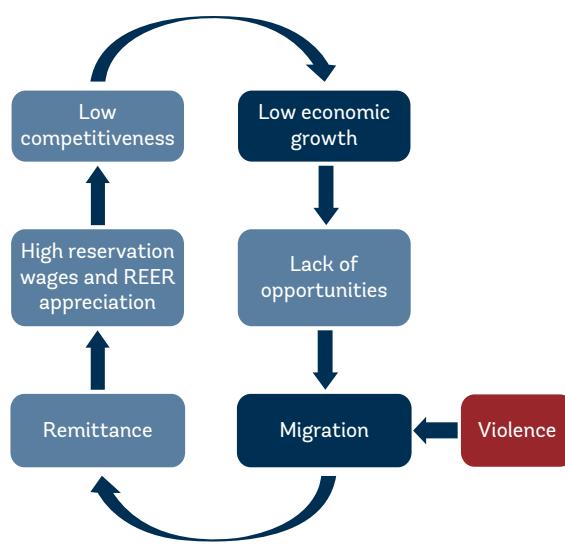


FIGURE 1.2 A Vicious Cycle between Emigration/Remittances and Low Growth



estimated 9 percent from private sector profits. Crime reduces competitiveness, discourages entrepreneurship and investment, and slows the pace of job creation. To put it simply: crime acts as a barrier to growth. However, the dynamics are more complex considering that low growth has a negative impact on the creation of economic opportunities, and this in turn lowers the opportunity cost of joining criminal groups. The implication is that high crime and low growth can create a vicious cycle that locks the country in a low level equilibrium.

Large levels of emigration and remittances flows are also presenting challenges to growth (figure 1.2). Large-scale emigration from Honduras is a relatively recent phenomenon that can be traced back to the aftermath of Hurricane Mitch in 1998. Today over half a million Hondurans (or 13 percent of the working-age population) live in the United States alone. Remittances approached 18 percent of GDP in 2014, the largest rate in Central America and among the top fifteen worldwide. The average monthly remittance reported by recipients is US\$477, almost 2.5 times the country's average monthly per capita income. Migration opens new possibilities for workers, and remittances have contributed to poverty reduction. Yet, evidence from Honduras indicates that the large

emigration and remittances flows have also negatively impacted productivity by shrinking the size of the labor force and increasing reservation wages. At the same time, the data suggest the presence of effects similar to "Dutch disease" as remittance inflows appear to distort domestic prices in Honduras, causing an appreciation of the real effective exchange rate. Both the impact on the labor supply and the exchange rate damage the international competitiveness of Honduran producers, hindering growth and economic opportunities.

Despite the significant development impact of high levels of crime and large emigration/remittances flows, these cycles do not provide a complete picture of the development challenges in Honduras. As noted above, high poverty has persisted for decades. Yet, both crime and emigration emerged in the late-1990s: the country's homicide rate in the early-1990s was below 20 per 100,000, similar to other Central American countries, while remittances flows in 1997, just before Hurricane Mitch, represented only 4 percent of GDP. This implies that neglecting pre-existing structural forces that were already preventing Honduras from developing in the 1990s before the surge of crime and emigration would result in an incomplete picture of the country's development challenges.

1.2 Beyond Crime and Emigration: Long-Standing Challenges to Competitiveness and Opportunities

Growth Challenges

An analysis of the barriers to growth uncovers long standing chronic constraints that have undermined productivity growth (on average, total factor productivity fell between 1960 and 2013), the development of a dynamic formal sector of the economy, and by extension, the creation of high quality jobs—key to sustainable poverty reduction. Elements identified in previous analytical works and confirmed in the SCD include: (a) an imperfect regulatory framework affecting both the labor market and certain product regulations that hinder competition in the domestic markets; (b) a lack of fiscal discipline and high levels of debt which have undermined macroeconomic stability in Honduras; (c) inadequate infrastructure; (d) a persistent shortage of skills and limited access to education for much of the population; and (e) relatively low access to capital (finance and property rights), particularly for SMEs.

Inclusion Challenges

There are also a number of critical elements affecting the unequal distribution of income. These include: (a) low access to, and poor quality of, basic services—approximately half a million Honduran children do not have access to potable water and 1.1 million children do not have access to basic sanitation; (b) an unequal distribution of access to services related to household income and location resulting in children from poor households facing limited access to essential services; and (c) a high minimum wage and other labor market regulations that provide formal workers with relatively high wages and labor protections, but do not reach the 80 percent of Honduran workers who remain in the informal sector.

Sustainability Challenges

The sustainability analysis also reveals challenges along the economic, social, and environmental

sustainability fronts: (a) continuing with the country's fiscal instability that led it to benefit from the Highly Indebted Poor Countries initiative, Honduras is again experiencing a debt buildup that limits the use of domestic resources for productive activities such as social and infrastructure investments; (b) beyond its impact on the investment climate and the allocation of investment, high levels of crime and violence undermine the country's social contract; and (c) the impact of natural hazards on Honduras is not simply a symptom of the country's geographical location, but rather of its low resilience. Structural sensitivity to economic shocks, chronic fiscal instability, low resilience to natural hazards, and high levels of crime and violence represent multiple dimensions of vulnerability that together pose a persistent risk to the achievement of Honduras' economic and social development objectives.

1.3 Deep Roots of the Challenges Faced: Institutional Quality

The fact that there are so many factors that emerge as development challenges may be an indication of a missing critical element in the diagnostic. The picture that emerges from the discussion indicates that poverty is high and persistent, affected by low growth, high inequality, and limited sustainability due to exposure to shocks across various fronts, and in turn, each of these are affected by a number of bottlenecks. That is, the focus thus far has been on identifying the *proximate causes* of Honduras' weak development outcomes (e.g., crime, fiscal instability, access to services, resilience). Is there a *root cause* affecting the proximate determinants?

This SCD argues that a plausible root cause behind the country's development outcomes is the low quality of its institutions (figure 1.3). Institutions are defined as the basic pillar of the state and include the following three elements: formal and informal rules and regulations (*rules*); the bureaucratic structure that implements and

FIGURE 1.3 A Cycle between the Quality of Institutions and Development Outcomes



Source: Adapted from the proposed framework of the forthcoming 2017 World Development Report.

enforces these rules (*capacity*); and the mechanisms to hold agents accountable for their actions (*accountability*). An examination of Honduras' rankings across different dimensions reported in the Worldwide Governance Indicators (WGI) suggests significant institutional challenges. For instance, Honduras scores in the lowest quartile in the world in the areas of control of corruption, rule of law, and government effectiveness, and below average in the areas of political stability, voice and accountability, and regulatory quality. While these aggregated measures provide limited information, they are corroborated with other measures: on the institutions pillar of the World Economic Forum's (WEF) Global Competitiveness Index, Honduras ranks 105th out of 144; on the Corruption Perceptions Index (CPI), Honduras ranks 126 out of 175 countries; the Government of Honduras provides the public with limited budget information and has scored 43 out of 100 in the Open Budget Index (OBI); on Judicial Independence, Honduras ranked 77 out of 142 in 2011–12; and, on the Press Freedom Index, Honduras ranked 135 out of 179 countries in 2011–12.

Beyond aggregate indicators, the analysis of the bottlenecks to growth, inclusion, and sustainability underscore issues related to institutional quality.

The literature on the role of institutions in economic development suggests that institutional weaknesses can lead to lower growth (through regulatory framework imperfections or inadequate enforcement, macroeconomic instability, negative effects of human capital accumulation and public infrastructure, limited access to finance, and, more generally, inefficiencies of the public sector affecting the implementation of programs), and high inequality (through governance effects on education and health, and the redistributive capacity of the state). For example, in Honduras:

- Macro-fiscal instability is, in part, the result of institutional quality. Inadequate fiscal management has played a large role in preventing Honduras from achieving sustained economic growth, and the devastating impact of both natural hazards and economic shocks is explained, in part, by low fiscal resilience and insufficient expenditure controls.
- High electricity costs result from losses of the state-owned electricity company, driven by inadequate electricity pricing mechanisms, high levels of theft and fraud, and poor maintenance of the distribution network. High energy costs can dramatically reduce economic returns not just for individual projects but to the entire infrastructure stock.
- Limited and unequal access to basic services is affected by the country's inefficient public spending. Public spending accounts for over a fifth of GDP, but most goes to public sector salaries. Driven by high minimum salaries and a lack of hiring oversight, the public wage bill now represents an estimated 9 percent of GDP and accounts for more than half of current expenditures. Education spending alone accounts for 5.5 percent of GDP, yet at present an estimated 1,000 additional secondary schools would be needed to achieve universal secondary education; instead, more than two-thirds of education spending is personnel costs. Poor targeting mechanisms, limited budget flexibility, and a weak accountability framework have been worsened by fiscal instability and a lack of budgetary credibility.

- The persistence of crime is attributable at least in part to the judicial system's lack of enforcement capacity. Challenges regarding law enforcement emerge from the United Nations Convention on Anti-Corruption (UNCAC) self-assessment of chapter III on Criminalization and Law Enforcement and chapter IV on International Cooperation. This assessment reveals that the legal and regulatory framework of Honduras complies with most provisions of the UNCAC in relation to criminalization of bribery and with most requirements relating to international cooperation by signing of a series of international treaties, which are now part of domestic law. However, it also reveals that major challenges remain in terms of law enforcement, with few cases being investigated, prosecuted and eventually punished with convictions.

Development outcomes, in turn, can also affect the quality of institutions, suggesting the presence of a third cycle affecting Honduras (figure 1.3). The literature linking institutions with development outcomes is complemented with another strand which emphasizes that the quality of institutions is *endogenous* to development outcomes and hence has the potential to create a feedback loop. The upcoming 2017 WDR framework identifies this feedback loop as a function of the power structure and norms present in the society; that is, the bargaining power of different groups can influence the evolution of the quality of institutions.

Changes in the bargaining power of agents and groups can influence the development path of institutional quality. One channel emphasizes that higher income levels are likely to lead to higher demand for quality institutions, while also implying more availability of resources with which to build institutional quality (Alonso and Garcimartin 2013). For example, as growth increases the profitability of firms, they are able to move away from areas where officials demand bribes and to areas with lower bribes (Bai et al. 2013). In this way, growth acts as a push factor and low bribes as a pull factor. In practice, this

would imply that countries can enter into a virtuous circle where high growth tends to reduce corruption and this feeds into higher growth, or conversely that corruption negatively affects growth and this feeds back an increase in corrupting activities. Another channel relates to income inequality. This is largely attributed to the importance of social cohesion, captured, for example, in the role of a sizeable middle class that both demands institutional quality and increases institutional quality through its willingness to contribute through taxation (Ferreira et al. 2013).

As with the cycles of crime and emigration, breaking the weak institutions-poor development outcomes cycle can be particularly challenging given its self-reinforcing nature. The existence of vicious cycles can make the task of reducing poverty and boosting share prosperity more complex because of the self-reinforcing mechanisms at play.

1.4 Priorities Ahead

The discussion above concludes that Honduras may be trapped in a low level equilibrium resulting from three self-reinforcing cycles: (a) low growth and high levels of crime and violence; (b) low growth and high migration/remittances flows; and (c) low growth/high inequality and poor institutional quality. These cycles reinforce each other and have important implications for a policy prioritization exercise (table 1.1).

A first implication is that escaping Honduras' low level equilibrium will require actions on several fronts. Looking for a single action or policy to act as an engine of development is insufficient; addressing the challenges emerging from some of the cycles and leaving aside those of others would risk leaving intact low growth attractors. Obviously, this is not to say that a single policy implemented in isolation will not have a positive development impact. Yet, when the objective is to dramatically alter the development dynamics, a coordinated effort along different fronts will be needed.

TABLE 1.1 Priorities Ahead: Policy Levers and Complementary Measures

Policy levers to break or revert the vicious cycles	
Crime and growth	<ul style="list-style-type: none"> • Strengthening violence prevention and law enforcement
Migration and growth	<ul style="list-style-type: none"> • Improving education and skills to compete
Institutions and development outcomes	<ul style="list-style-type: none"> • Improving the quality of institutions through <ul style="list-style-type: none"> - strengthening of the rule of law and the judiciary, - capacity building, and - improvements in the accountability framework
Complementary measures	
Boosting growth	<ul style="list-style-type: none"> • Promoting macroeconomic stability, including fiscal sustainability • Improving infrastructure
Fostering inclusion	<ul style="list-style-type: none"> • Strengthening the targeting and coverage of conditional cash transfers • Improving access to basic services • Promoting active labor market policies to improve job matching, particularly for low skilled workers
Promoting resilience	<ul style="list-style-type: none"> • Strengthening prevention and disaster risk management

A second implication is that the needed actions will need to generate a “big push,” strong enough to alter the existing dynamics. Marginal interventions are unlikely to break or revert the self-reinforcing forces that have kept Honduras in a low level equilibrium. It is not that modest interventions that go in the right direction will not have a positive impact on development outcomes, but rather, that these interventions are limited in what they can achieve given the complexity of the challenges involved.

Third, it is important to identify entry points, or policy levers, that can help break or revert the existing cycles—and, given the magnitude of challenges, they might need to be supported through additional policies that will foster complementary progress in growth, inclusion and sustainability. Priority areas to attack the challenges created by the cycles would have to focus on (a) improving education and skills to compete; (b) strengthening violence prevention and law enforcement; and (c) improving the quality of the institutional framework, with a focus on rule of law, capacity building and fostering accountability.

Breaking the cycle between violence and low growth requires a concentrated focus on prevention and improved law enforcement to reduce the high social and economic costs imposed by crime and violence. Reducing crime and violence enhances social sustainability and improves the credibility and legitimacy of the government.

The poor stand to gain the most from a reduction in crime and violence since they are often the victims. Less crime implies reductions in production costs as expenditures associated with buying protection are reduced. Smaller enterprises will gain, with a potential positive impact on employment generation and hence inclusion. Lower crime and violence is likely to improve the investment climate, support domestic entrepreneurship and increase foreign investment inflows. A drop in crime and violence can also create stronger value chains, potentially contributing to an increase in exports and open space for other areas of economic activity to grow, such as tourism. In addition, it may reduce Honduras’ out-migration and incentivize migrants to return, invest and transfer skills back into the economy.

Skill upgrades can be a powerful tool in fighting crime and violence. For example, the *Programa de Apoyo Temporal al Empleo* (PATI) implemented in El Salvador contributed to lowering the levels of crime. The program offered income support to vulnerable individuals in urban areas with program beneficiaries committing to participate in community activities and capacitization programs to improve their employability and entrepreneurial abilities. This type of program increases the opportunity cost of joining a criminal group by increasing both the present income as well as participants’ future potential income.² At the same time, addressing crime will

also require a strategy that reduces impunity, strengthen the judicial system, and enhance the accountability of the government, including its actions to reduce impunity (Calvo-Gonzalez and Lopez 2015).

Improving education and the skills to compete can help break the cycle between migration and low growth by lowering the pressure of high reservation wages. Excessively high reservation wages, which are partly the result of large inflows of remittances, hamper labor market development as workers require wages that are above their marginal productivity. Increasing labor productivity through investment in education and skills would help bridge this gap and would positively impact growth, inclusion, and sustainability, including crime prevention. Better learning outcomes, even at the current levels of enrollment, would help equip the youth for the acquisition of skills demanded by the labor market. In this regard, tackling the country's low secondary school completion rate and low access to vocational training is fundamental to promote improved job outcomes and generate greater productivity and innovation. Moreover, the country may follow an active policy of training adults focused on skills that facilitate entry into better occupations, including providing training to those formerly involved in crime and gangs. It is also likely that improved educational outcomes contribute to higher retention rates at the secondary level. Education, as noted above, is also a key building block for other priorities, in particular reducing crime and violence.

The country's institutional framework has implications for growth, inequality, and resilience. Even though improvements to the quality of institutions are difficult to achieve, Honduras' ability to harness its potential hinges on improving the capacity of the public sector to plan and implement effective policies, execute public investment projects, deliver services, and increase accountability. The discussion in the SCD concludes that improvements to the quality of institutions in Honduras will require a broad agenda that includes: (a) strengthening of the rule of law and the judiciary, (b) building

capacity for implementation and enforcement, and (c) improvements in the accountability framework.

Addressing the challenges emerging from the three cycles feeding into Honduras' weak development outcomes will also require policies that complement those priorities identified as entry point to the cycles, particularly those that have a direct impact on (a) reigniting economic growth and (b) fostering inclusion.

Promoting fiscal sustainability is perhaps the most critical objective to reigniting economic growth over the medium term. While measures for reigniting growth in the short term are difficult to identify, a stronger fiscal position that is achieved now and sustained over the medium to the long-term will set the basis for progress on service delivery, and growth and employment. Fiscal deficits and slower economic growth since the 2009 crisis have increased public debt, affecting investor confidence. While the authorities have recently made strides to reduce the fiscal deficit, fiscal consolidation will require additional reforms that enhance public financial management and rebalance expenditures from current spending towards capital spending. Curtailing the fiscal losses in the power sector will also bolster the fiscal position, and in this regard the current environment of low oil prices does provide an opportunity to advance an electricity subsidy reform. At the same time, there is scope for mobilizing additional tax revenues by improving tax and customs administration and reducing tax exemptions which represent a large share of GDP.

With a view to generating sustained growth and facilitating further insertion into global markets, it is important to address the constraints of expensive and low quality infrastructure services. Key objectives should include a modernization of the state owned electricity company (*Empresa Nacional de Energía Eléctrica [ENEE]*) through actions aimed at improving: (a) energy pricing and energy efficiency mechanisms, such as modernizing the energy matrix towards cleaner and cheaper energy sources to reduce the dominance of thermal power; (b) the legal framework

to reduce fraud and theft; and (c) the corporate governance of ENEE, including building capacity of the newly created energy regulatory agency. To promote further insertion into global markets, a focus on port infrastructure and improved road maintenance is warranted and should be combined with improved logistics and regulations to reduce waiting times while improving customs enforcement. Expanding the road network is important to promote the inclusion of poorer rural areas and small producers, accounting for many of the country's extreme poor. These investments, if planned and executed well, also represent an opportunity for growth in the near term, providing opportunities for Public Private Partnerships and the creation of jobs.

Measures aimed at boosting growth also support a more competitive private sector and help generate more demand for labor, creating much needed jobs. As in other economies, small and young firms generate a disproportionate share of job creation. Reducing their exposure to economic volatility through a healthier fiscal environment allows these firms, which are often the least able to survive shocks, important economic space to grow. Reducing operating costs through improvements in the energy sector and transportation would boost productivity—bolstering the potential for productivity growth in key industries, including agribusiness and manufacturing. Combined with the policy levers designed to address the cycles of crime, emigration, and institutions identified above, these measures would be expected to promote a better business climate, a more skilled workforce, and lead to more job creation by the private sector.

The challenge of fostering inclusion cannot wait for education and skills to have an impact. Eighty percent of Honduran children live in poverty and a majority do not finish secondary school. There is strong evidence that the current social assistance programs are having an impact in the reduction of poverty and should be expanded to cover all eligible families living in extreme poverty. Over the long-term, efforts at inclusion need the support of good-quality basic services that empower the population with the

assets both to create and to profit from opportunities. Similarly, reducing child malnutrition should figure as a high priority: studies estimate that malnutrition is responsible for approximately 45 percent of under-five mortality and that stunting, in particular, is estimated to contribute to GDP losses of up to 11 percent (Black et al. 2013; Horton and Steckel 2013). In order to improve the chances that each child in Honduras reaches his or her potential, the country needs to ensure that young children have access to adequate food, health services, and a healthy environment (including access to clean water and sanitation facilities), and appropriate medical care, especially during pregnancy and the first two years of age. A solid insertion of Hondurans into the labor market is the best bet for the country to achieve sustainable inclusion. This calls for active labor market policies that work towards making markets more efficient and inclusive by addressing issues of information, lack of skills, and low job creation. Minimum wages set in line with market wages have the potential to unleash investment and production in high productivity sectors and contribute to a better allocation of resources in the economy. Addressing skills and information problems can translate to improved employment opportunities for the young and poor and, in turn, can be a countervailing force to violence and crime.

One final reflection regards the need to focus on policies that go beyond average higher growth rates and lower inequality, and include vulnerability considerations. For this, it will be critical that Honduras continue building resilience to natural hazards as these are expected to increase in frequency and severity due to the expected impacts of climate change. An ample agenda is already under implementation for building institutions and improving infrastructure and local planning to build resilience to natural hazards. Greater attention is needed, however, to the impact of “small” natural events that affect the lives of the poor in a localized but dramatic manner. In this regard, the capacity of households to manage the impact of natural hazards can be enhanced by linking them to saving mechanisms

and increasing the availability of financial instruments, such as agricultural insurance. Similarly, improved capacity to manage natural resources, including water and forests, can decrease vulnerability of households to hazards like droughts and landslides.

There is no doubt that this is a complex agenda that will require persistence and commitment over time. But it is a worthwhile endeavor as it would allow Honduras to move from being a country of potentials to one of actuals.

1.5 Process and Knowledge Gaps

This SCD draws on existing analysis and publications, new analysis, and, importantly, consultations and ongoing dialogue with stakeholders in Honduras. Throughout discussions, there was broad consensus on the diagnosis of challenges faced in Honduras, in particular the country's high rates of crime and violence and institutional quality, as well as priorities ahead.

Although there are some analyses of the nature and causes of Honduras' high and persistent levels of poverty and inequality, as well as its volatile growth, this SCD identifies several knowledge gaps in the existing analyses. In identifying knowledge gaps, the SCD focused on areas where new information could help inform specific actions in the priority areas. Eight concrete knowledge gaps were identified:

- What are the determinants of low returns to investment in Honduras?

- What is the full cost of crime to the Honduran economy?
- What is the effect of labor market regulations on job creation, informal employment and unemployment in Honduras?
- What is the impact of the country's high minimum salaries on job creation, particularly for unskilled workers?
- What are the challenges facing increased female inclusion into the labor force?
- How does crime affect the welfare of the bottom 40 percent in Honduras?
- What is the relationship between vulnerability, extreme weather events and poverty?

1.6 Structure of the SCD

This SCD is structured as follows: the second chapter examines trends in poverty and shared prosperity in Honduras and identifies the roles of economic growth, labor markets, and social policy for poverty and inequality reduction. The following three chapters provide analyses of the main factors affecting inclusion, growth, and sustainability. Chapter 3 analyzes the drivers of growth and identifies the key constraints to further growth. Chapter 4 assesses the drivers associated with the country's limited inclusion and high inequality. Chapter 5 identifies risks to the sustainability of development, including adequate fiscal policy, the role of crime and violence, and environmental hazards. The final chapter takes stock of these elements and identifies priorities ahead.

Notes

1. The global average homicide rate in 2012 was 6.2 per 100,000 while countries with more than 20 per 100,000 are considered to have high homicide rates. *Source:* United Nations Office on Drugs and Crime. 2014. "Global Study on Homicide, 2013."
2. The World Bank supported a similar cash for work project in Honduras, Employment

Generation in Poor Urban Neighborhoods, which targeted at risk youth and unemployed heads of household with young children. The project also included a number of crime and violence prevention training and development of human capital, including conflict resolution and preparation for employment.

Chapter 2

Poverty

In 2013, more than half of the Honduran population lived below the poverty line, with six out of ten rural families living in extreme poverty. Honduras also ranked among the most unequal countries in the region, and its middle class was among the smallest in LAC. Low levels of economic inclusion, limited social mobility, and the vulnerability of lower-income households to a wide range of shocks have made poverty in Honduras especially deep and intractable. Over the past 15 years, many Hondurans have left the country to seek opportunities abroad, and due to years of large-scale migration Honduras now has one of the world's highest levels of remittances as a share of GDP. Although remittances have enormous potential to reduce poverty and increase household incomes, emerging evidence suggests that they may also be causing Dutch Disease effects, as well as draining the country's human capital stock and potentially discouraging labor force participation among domestic workers. Remittances, together with labor income and employment, have driven poverty trends over the last decade. Cash transfers have had a positive impact on extreme poverty and social indicators, but their scope is relatively limited.

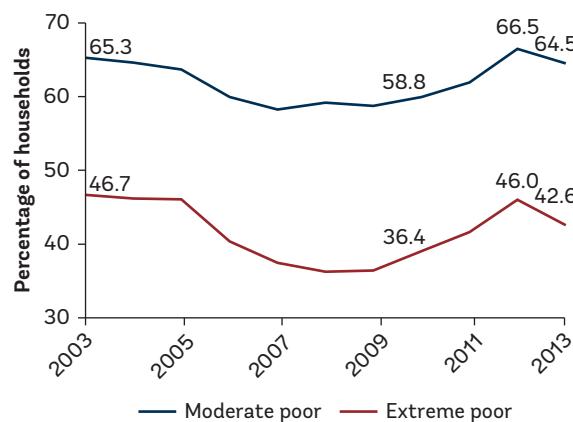
2.1 Trends in Poverty Reduction and Shared Prosperity

Due to the severe multidimensional vulnerability of both individual households and the country as a whole, poverty rates in Honduras are among the highest in the Latin America and the Caribbean (LAC) region. In 2013, almost 65 percent of Honduran households were below the poverty line, with 43 percent in extreme poverty (figure 2.1).¹ Although modest gains were made during the global economic expansion of the

mid-2000s, these were wiped out during the final years of the decade, when the impact of the global financial crisis was magnified by domestic political instability. By 2012, both the moderate and extreme poverty rates had returned to their 2003 levels. This repeats what has become an unfortunate pattern in Honduras, marking the fourth time since 1990 that sudden shocks have undone years of progress in poverty reduction.

Despite these setbacks, the share of the population living on less than US\$1.90 per day—the global extreme poverty line—has declined over time, falling from about 44 percent of the population in 1990 to 19 percent in 2013. Nevertheless, Honduras' extreme poverty rate remains the second highest in the LAC region and trails that of peer countries (box 2.1).² Meanwhile, the moderate poverty rate also experienced a modest and uneven long-term decline, falling by roughly 20 percentage points since 1990, though it too remains one of the highest in LAC. In 2013, both

FIGURE 2.1 Gains in Reducing Poverty during the Mid-2000s Were Erased after 2008
(Official household poverty rates, %, 2003–13)



Source: Work Bank estimates based on data from the Honduran authorities.

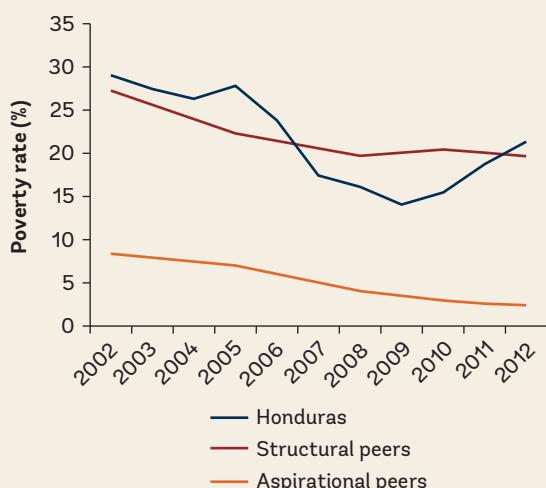
Note: This figure reports the share of households living in poverty.

BOX 2.1 International Benchmarking: Poverty and Inequality^a

Honduras' global extreme poverty rate is higher than its structural peers and four times higher than its aspirational peers; its inequality rates are the highest among both structural and aspirational peers. As of 2012, the last year for which comparable global poverty rates have been published, Honduras' extreme poverty rate was slightly higher than the average poverty of countries identified as structural peers (figure B2.1.1). Compared to aspirational peers, Honduran poverty was four times, or about 19 percentage points, higher. Similarly, inequality, measured using the Gini Coefficient, has been consistently higher in Honduras relative to its peers (figure B2.1.2).^b On average, both structural and aspirational peers have inequality of around 0.40 throughout the period even while Honduras' fluctuates near 0.60. Notably, Peru and El Salvador have decreased their inequality levels over the last decade: Peru's Gini decreased from 0.53 in 2003 to 0.45 in 2011 while El Salvador's decreased to 0.42 during the same period.

FIGURE B2.1.1 Honduras Is Poorer than Most Structural Peers

(Poverty headcount ratio at US\$ 1.90 a day (2011 PPP) Peers, 2002–12)



Source: World Development Indicators and PovCalNet.

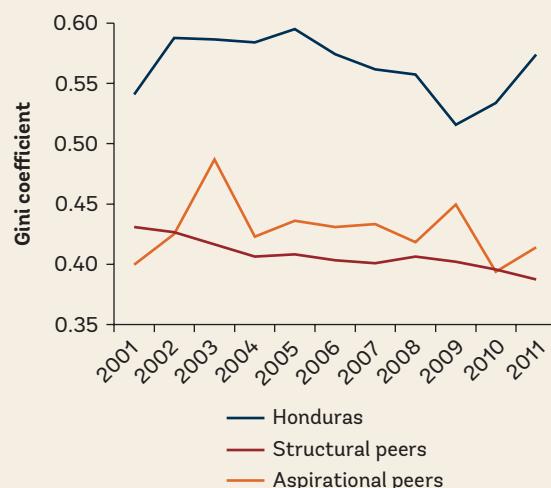
Note: See appendix A for how the aspirational and structural peers were identified. The average Gini coefficient was calculated for structural and aspirational peers. For Nicaragua and Chile values were interpolated using WDI data for years in which data were unavailable. For Senegal, only 2001, 2005 and 2011 were available. For Morocco only 2001 and 2007 data were available. For Latvia 2001, 2003, 2005, 2007, 2009 values were missing. Finally, for Lithuania 2007 and 2009 were missing.

a. For global comparisons, two sets of countries have been identified. Structural peers and aspirational peers (see appendix A).

b. Care should be taken in interpreting the Gini coefficient across regions as many countries outside of the LAC region rely on welfare aggregates based on consumption, while in LAC, the welfare aggregate is based on income. Income-based inequality measures tend to be higher than consumption-based measures.

FIGURE B2.1.2 Honduras Has Higher Inequality than Its Structural and Aspirational Peers

(Gini Coefficient, Peers, 2003–11)

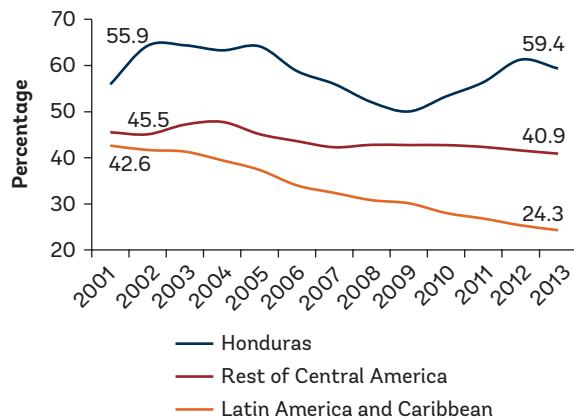


the moderate and extreme poverty rates decreased for the first time since 2009 (figure 2.2).

Slow and inconsistent poverty reduction in Honduras is a departure from regional trends. Poverty rates in LAC have declined steadily and substantially over the past decade. With a gross domestic product (GDP) per capita of US\$2,291, just 30 percent of the LAC average,

Honduras is one of the poorest countries in a growing region. The aggregate LAC poverty rate fell from 41.3 percent in 2003 to 25.3 percent in 2012. Meanwhile, Honduras' poverty rate fluctuated between 53 and 65 percent, and it is now more than double the LAC average. While Central America has lagged the broader regional trend, its overall poverty rate has modestly

FIGURE 2.2 Poverty Reduction in Honduras Has Been Slow and Uneven Compared with Regional Averages
(Headcount poverty rates at \$4/day, 2001–13)



Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank).

declined, and since 2009 poverty rates in Honduras have diverged substantially from those of its neighbors.

Who Are the Poor?

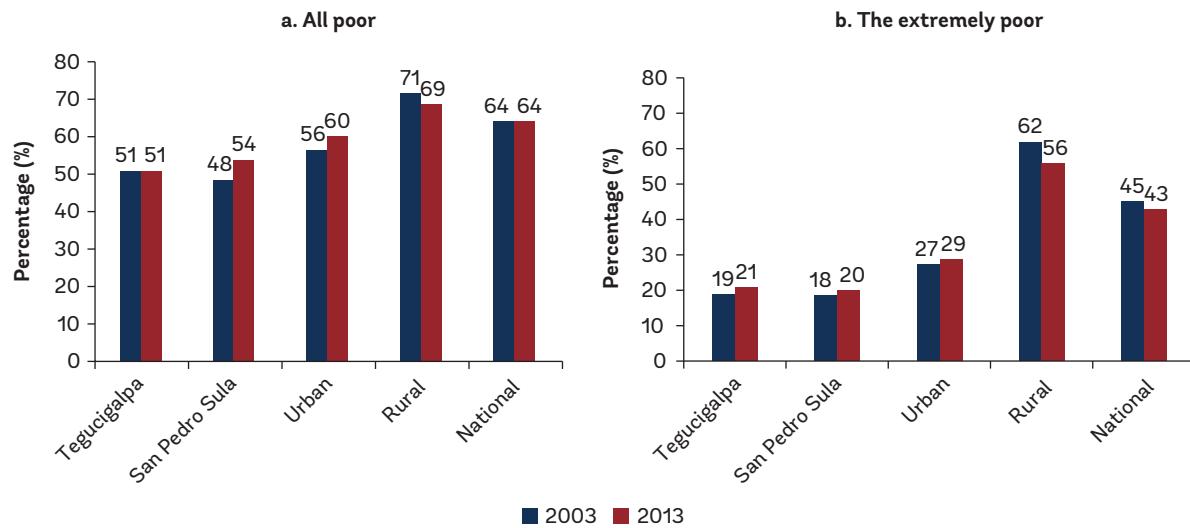
In Honduras more than half of the poor, and two-thirds of the extreme poor, live in rural areas (figure 2.3). Reductions in both extreme and moderate poverty between 2003 and 2013 were driven by gains in rural areas, while the rest of the country experienced a slight increase in both. Rural poverty is most heavily concentrated in the western and southern areas of the country, known as the “Dry Corridor” (*Corredor Seco*) (Weiss 2014). The rural poor overwhelmingly rely on agriculture as their principal livelihood. Seventy-two percent of agricultural families in Honduras are engaged in semi-subsistence farming, which is typically characterized by low marginal productivity and high vulnerability to shocks (Weiss 2014). Between 2008 and 2013, self-employment represented about half of total employment in rural areas.

Nonmonetary poverty is most acute among the rural population, and rural households are far more likely to suffer from a lack of basic services. The Unsatisfied Basic Needs (UBN)

index is a measure of poverty based on access to basic goods and services, rather than income or consumption. Using municipality-level rates of access to basic goods and services, the UBN is approximated in this report as the average of the share of households without access to six fundamental services. It identifies the share of families which: (a) include children aged 6–14 who are not attending school, (b) lack access to running water, (c) lack access to improved sanitary facilities, (d) lack access to electricity, (e) live in housing with a dirt floor, or (f) live in overcrowded housing. Honduras’ average UBN score across all administrative departments is 26.3 percent. However, a breakdown by administrative department reveals substantial geographic differences, ranging from Islas de la Bahía, which has the lowest UBN score at 6.6 percent, to Gracias a Dios, which has the highest at 47.7 percent. The urban centers have lower levels of UBN as shown in map 2.1. Departments in which the majority of the population is comprised of Indigenous Peoples (IP) and Afro-descendants (AD) (Gracias a Dios, La Paz and Intibucá) have UBN scores that are worse than the national average (box 2.2).

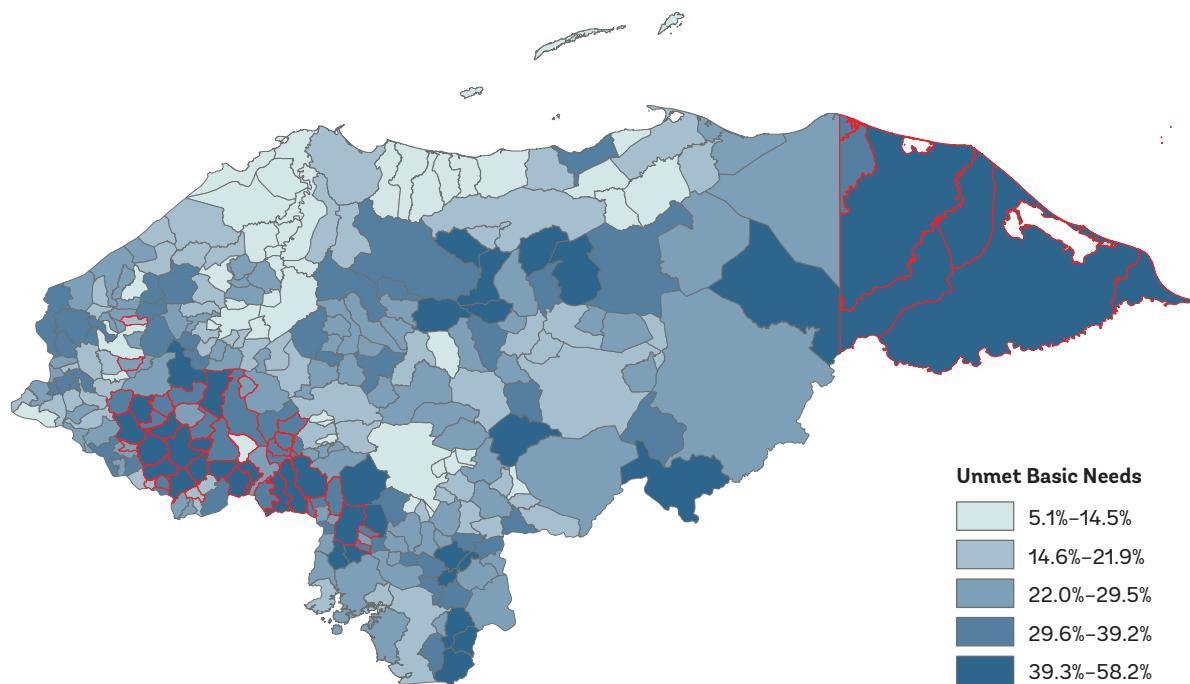
Children in Honduras are especially likely to live in poverty and suffer the consequences of malnutrition and inadequate access to clean water and sanitation. In 2013, nearly 80 percent of Hondurans younger than 15 lived in poverty, in contrast to 64 percent of prime-age adults (table 2.1). Approximately one in four children in Honduras is so undernourished that their development is stunted, with negative implications for their future learning abilities and labor capacity.³ The World Food Program estimates that 60 percent of Hondurans are food insecure, and in the *Corredor Seco*, where poverty is most acute, 58 percent of children under five suffer from chronic malnutrition. Contributing factors include limited access to clean water, a nutrient-deficient diet, poor sanitation and insufficient breastfeeding (World Bank 2015c).⁴ Chronic malnutrition is about twice as common among children in rural areas (28.8 percent) than in urban centers (14.6 percent).

FIGURE 2.3 Poverty Rates Have Been Consistently Higher in Rural Areas than in Urban Centers
 (National Poverty Rates by Region, 2003 vs. 2013, percent)



Source: World Bank estimates based on the Honduran household surveys (*Encuesta Permanente de Hogares de Propósitos Múltiples*, EPHPM).

MAP 2.1 Indigenous Peoples and Afro-Descendants Often Live in Areas with Lower Access to Basic Services
(Map of unsatisfied basic needs)



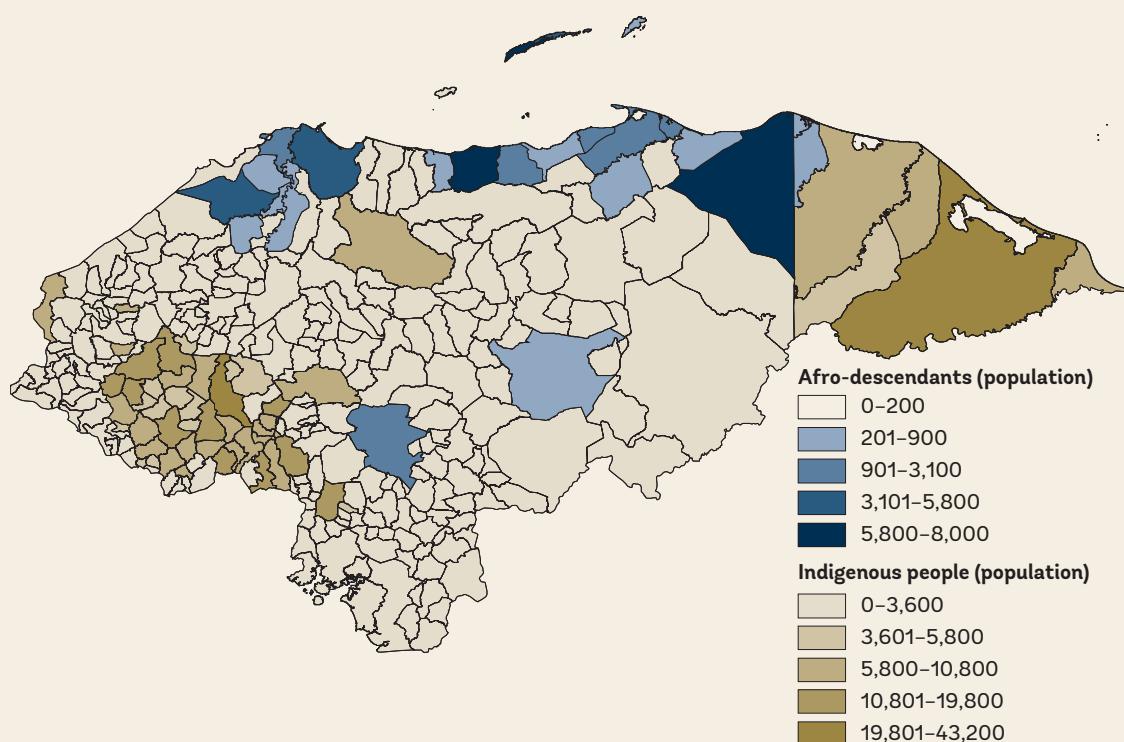
Source: World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.
 Note: Departments in which the majority of the population is comprised of IP and AD are outlined in red.

BOX 2.2 Indigenous Peoples and Afro-Descendants in Honduras

An estimated 8.6 percent of the Honduran population is made up of Indigenous Peoples and Afro-descendants.^a There are seven indigenous groups (Miskito, Pech, Tawahka, Nahua, Tolupán, Chortí y Lenca), one group considered both indigenous and Afro-descendant (the Garifunas) and one Afro-descendant group, the Creoles. While the IP are concentrated in the southwest and northeast corners of the country, the AD are primarily along the Caribbean coast (map B2.2.1). Social structures in these groups remain strong and, except for the Lenca and the Chortí, the groups have kept their languages. Given the lack of information about the IP and AD populations in the Honduran household surveys, there are no official estimates of the poverty rates for these groups. However, other analysis suggests that poverty rates are high among indigenous groups: rough estimations from indigenous organizations indicate that over 70 percent live in poverty and over half of the population is not employed (Faúndez-Meléndez and Valdés-Castillo 2011). Agriculture is the predominant activity for most IP and AD groups in Honduras.

MAP B2.2.1 Honduras's Indigenous Peoples and Afro-Descendants Are Distributed across the Country

(Map of indigenous peoples and Afro-descendants)



Source: World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.

Note: For each department, only the population of the group (IP or AD) with the largest population is reported. For this map, the Garifunas are included as AD even as they are considered both AD and IP.

a. Estimates are based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.

TABLE 2.1 Poverty Rates, by Age and Gender of Household Head, 2003–13

Year	Age group				Gender of head	
	<15	15–25	25–65	65+	Female	Male
2003	77.5	65.4	63.5	71.2	71.1	69.4
2008	76.9	64.9	60.3	67.9	69.8	66.1
2012	79.8	68.3	65.5	67.9	70.7	70.6
2013	79.3	67.2	64.0	66.5	70.5	69.2

Source: World Bank estimates based on the Honduran household surveys (*Encuesta Permanente de Hogares de Propósitos Multiples, EPHPM*).

Extreme poverty remains pervasive in Honduras, yet there are signs of improvement in education and labor force participation among households below the extreme poverty line. The Government has made substantial investments in the human capital of the extreme poor over the past decade (appendix C). As a result, school enrollment rates among children aged 6–12 living in extreme poverty rose by 16 percent, and the average years of education among heads of extreme poor households increased by more than 1 year to 3.6 years. Nevertheless, the share of 13–18 year olds enrolled in school remains low for both the poor and extreme poor at just 15 percent. Labor market outcomes show mixed signs of improvement for the poor and extreme poor. Unemployment rates have fallen, particularly for men, while the female labor force participation rate among the extreme poor increased. Even so, female labor force participation among the extreme poor remained at just 37.1 percent, below the labor force participation rate of 49.8 percent for the population as a whole.

Households in the Poorest 40 Percent Continue to Live in Extreme Poverty

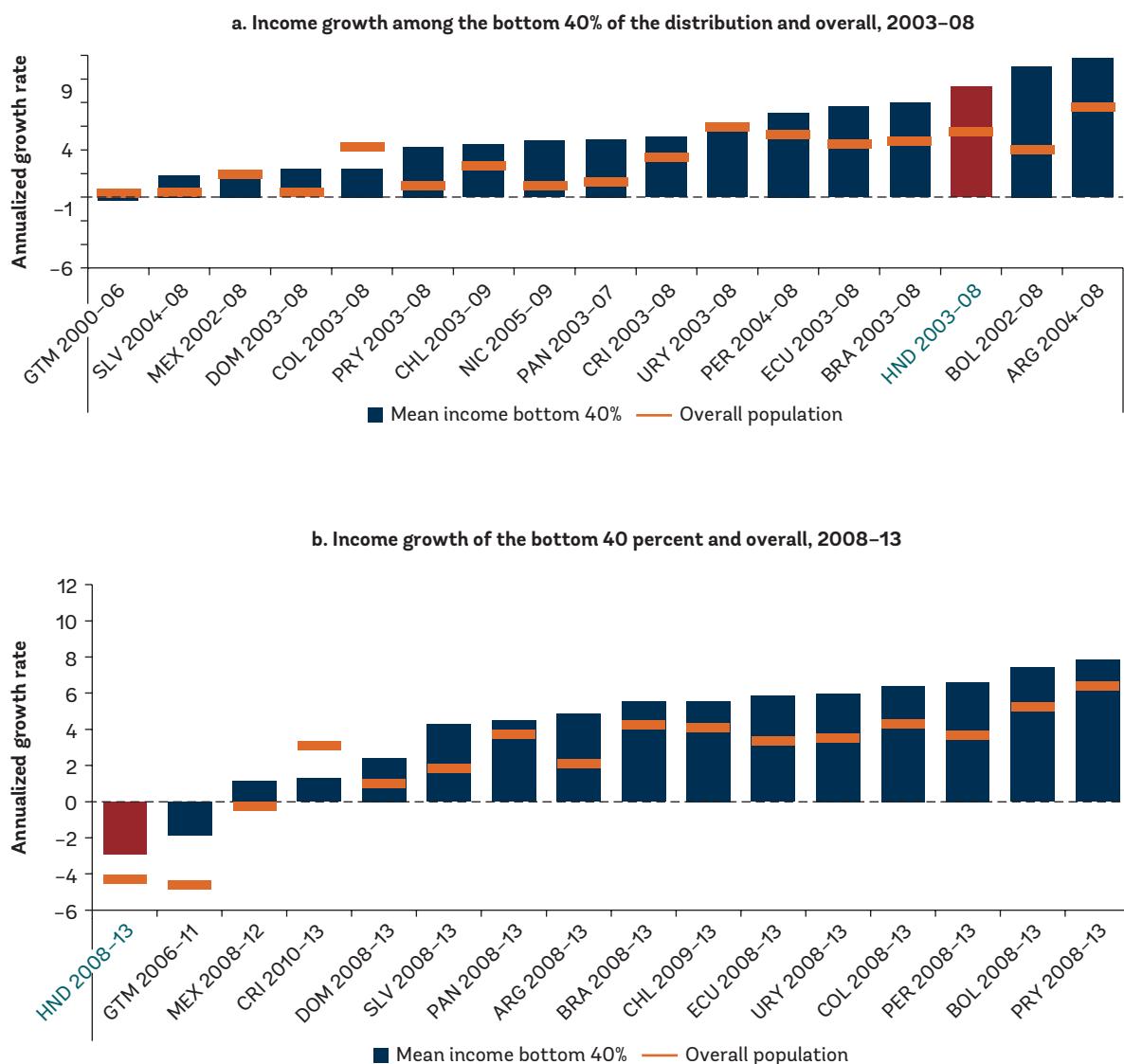
Hondurans in the bottom 40 percent of the income distribution have an average income of less than US\$1.70, just half of the average for LAC as a whole.⁵ The economic expansion of the mid-2000s was generally pro-poor, and incomes rose among the bottom 40 percent at

an annualized rate of 9.4 percent, faster than the rate for the population as a whole (figure 2.4). In fact, Honduras outperformed most LAC countries in promoting shared prosperity during this period. However, these gains were partially erased in the wake of the political and economic crises at the end of the decade, and from 2009 to 2013, the average income among the bottom 40 percent contracted by an annualized rate of 2.9 percent, while average incomes fell by 4.3 percent. These outcomes were the worst in the LAC region and underscore the importance of vulnerability in perpetuating poverty in Honduras.

Income Inequality: The Missing Middle Class

Income inequality in Honduras is among the highest in LAC, and periods of inclusive growth have been followed by contractions and regressive recoveries.⁶ Between 2003 and 2013, inequality fell substantially across the LAC region (figure 2.5).⁷ After spiking in 2005, inequality in Honduras declined rapidly through 2009 as income growth among the poorest households outpaced growth among the better off (figure 2.6). GDP contracted in 2009, yet inequality continued to decline as the initial effects of the crisis fell hardest on households in the top decile, which saw their aggregate income drop by 13.8 percent.⁸ Poor and middle-class households also suffered as the economy contracted, and they were far slower to recover. From 2010 to 2011, inequality again increased as rebounding growth benefited the top of the distribution, even as incomes continued to fall among the bottom 90 percent. After plateauing between 2011 and 2012, the Gini coefficient fell sharply to 0.53 in 2013 as GDP growth slowed. This drop in inequality was due to a combination of income growth among lower deciles and declining income among the top decile. This may signal a return to a more progressive growth pattern, as income growth at the bottom

FIGURE 2.4 Growth in Honduras during the Mid-2000s Was among the Most Pro-Poor in LAC



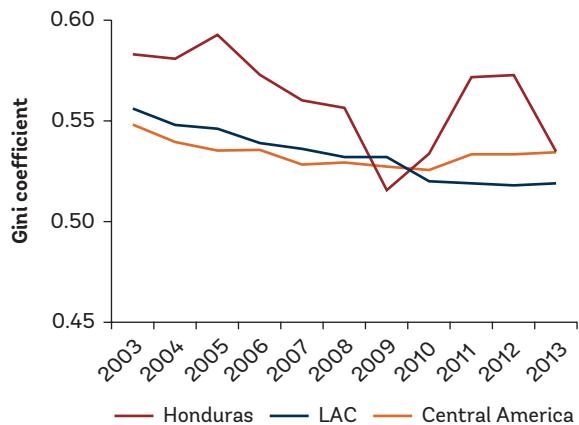
Source: World Bank 2015e.

of the distribution has again surpassed growth at the top.

After expanding modestly during the mid-2000s, Honduras' middle class contracted in the wake of the domestic and global crises.⁹ As poverty fell from 2005 to 2009, the middle class expanded from 10.9 percent to 15.7 percent of the population. However, by 2011 the middle class had shrunk to less than 13 percent and by 2013 it had returned to 10.9 percent, making it

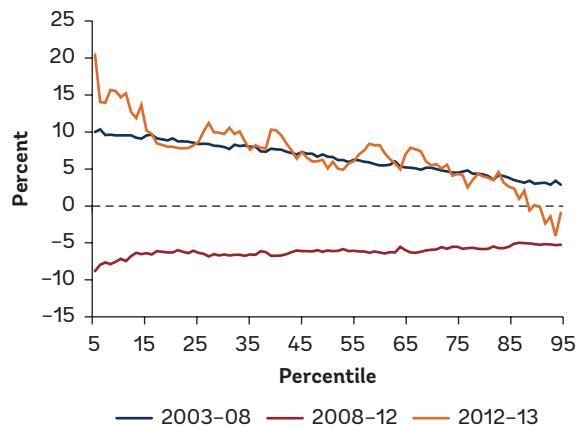
one of the smallest in LAC (figure 2.7). In many countries a large and growing middle class has been associated with stronger economic growth, better governance quality and a more stable society. In Honduras, the share of low-income households—those that are above the poverty line but not yet in the middle class—rose in the years prior to 2009, reflecting the economy's modest success in enabling households to escape poverty. After 2009, however, the share declined

FIGURE 2.5 Honduras Remains One of the Most Unequal Countries in LAC
(*Gini coefficient, 2003–13*)



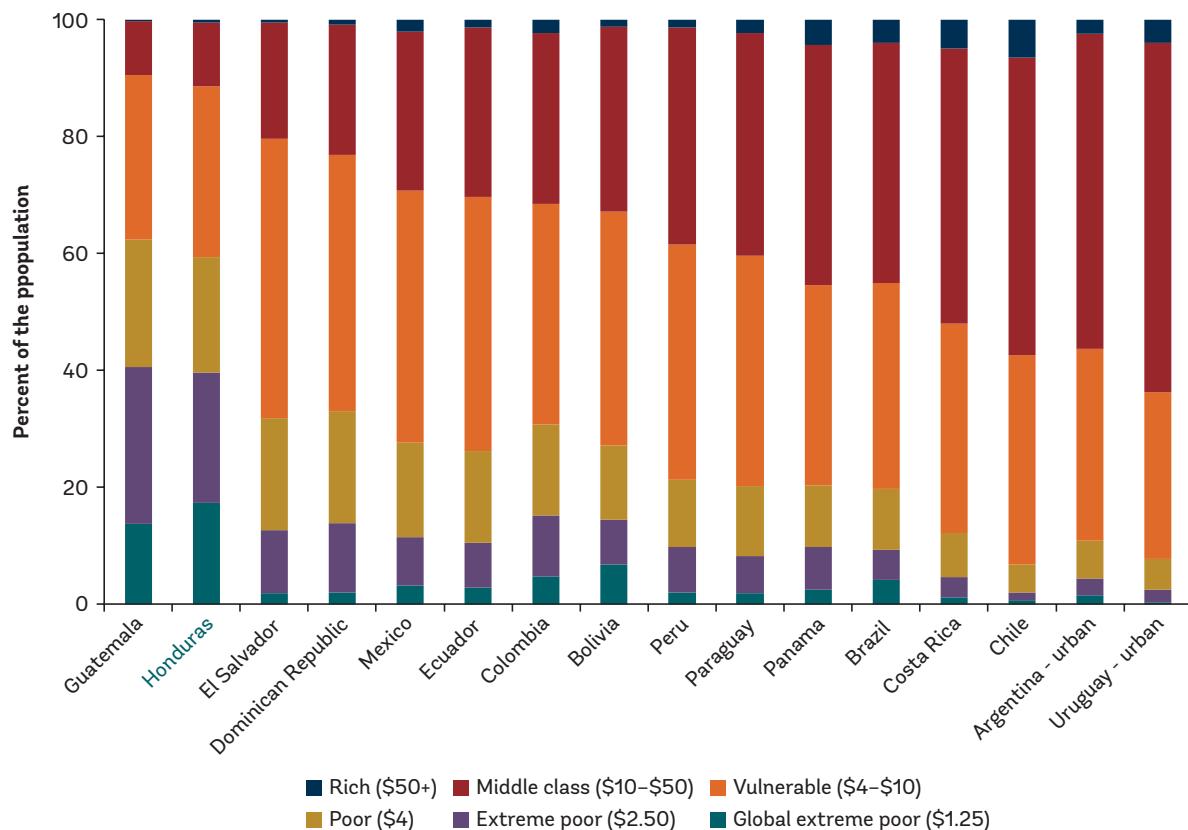
Source: World Bank estimates based on the Honduran household surveys (*Encuesta Permanente de Hogares de Propósitos Múltiples, EPHPM*) and the Central Bank of Honduras.

FIGURE 2.6 Recent Income Growth Has Been Pro-Poor
(*Growth incidence curve, 2003–13*)



Source: World Bank estimates based on EPHPM.
Note: The bottom and top 1 percent are not reported in these GICs as the estimates of income at the extremes are particularly noisy in household surveys.

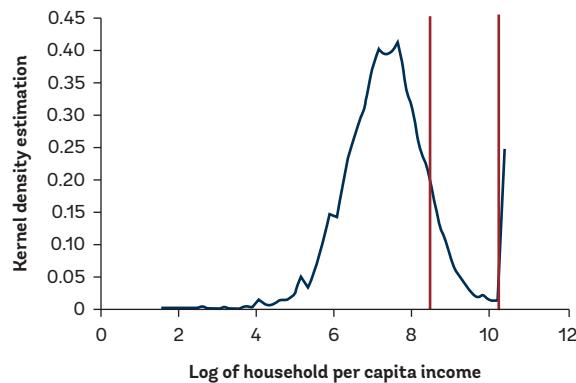
FIGURE 2.7 Honduras Has a Small Middle Class Compared with Other LAC Countries
(*Population distribution by income level, 2013*)



Source: World Bank estimates based on SEDLAC (CEDLAS and the World Bank).

Note: Estimates are based on harmonized national household surveys using 2013 surveys whenever possible. All monetary values are reported in 2005 US dollars adjusted for purchasing power parity.

FIGURE 2.8 Honduras Suffers from a Missing Middle Class
(Kernel density of per capita household income, 2013)

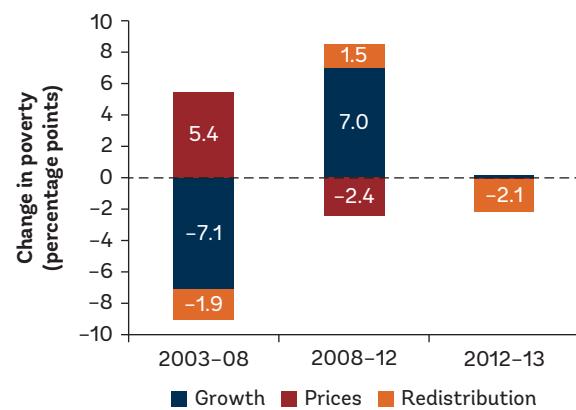


Source: World Bank estimates based on SEDLAC (CEDLAS and the World Bank).

Note: The vertical lines represent US\$10 and US\$50, defining the middle class. The income of individuals with more than US\$50 per day is plotted as US\$50.

FIGURE 2.9 Income Growth Drove Changes in Poverty between 2003 and 2013

(The contribution of income growth and income distribution to poverty reduction, %)



Source: World Bank estimates based on EPHPM.

again as many households fell back below the poverty line.

The country's small middle class and high level of income inequality is a concern among the Honduran public. Most households are clustered at the far ends of the income distribution, leaving a "missing middle" between them (figure 2.8). Opinion polls indicate that almost 47 percent of Hondurans find the current distribution of income to be unjust, and 34 percent regard it as very unjust.¹⁰ The 70 percent of the

population currently living in poverty together accounted for less than a third of total household income in 2013. Meanwhile, the wealthiest one percent received 13 percent of total income in 2013.

2.2 Causes of Poverty and Drivers of Poverty Reduction

Poverty and Vulnerability in Honduras: the Role of Resilience in Development Outcomes

It is difficult for poor household in Honduras to rise above the poverty line, and those that do remain highly vulnerable to shocks that can push them back into poverty. Only 6 percent of households that escaped from poverty between 2003 and 2007 were still out of poverty in 2011.¹¹ These households saw their income grow by almost 50 percent over the period. Chronically poor households in rural areas experienced stronger income growth (around 40 percent) than those in urban areas (around 20 percent).¹² At both individual and household levels, rural residence is associated with much greater levels of chronic poverty. Sixty-five percent of rural households were chronically poor, compared to 31 percent of urban households, and rates of extreme poverty were particularly high among agricultural workers. Credit constraints, low marginal productivity of land and labor, limited educational attainment, and the absence of effective risk-mitigation strategies prevent the poor from accessing new economic opportunities and increase their susceptibility to negative shocks. These factors reduce social mobility and increase the likelihood that households that escape poverty will be pushed back into it.

Natural hazards can have a particularly devastating effect on the poor, and in Honduras the absence of crucial physical, institutional and economic infrastructure leaves poor families especially vulnerable to natural disasters. Honduras suffers from environmental hazards ranging from hurricanes and tropical storms to droughts and

erratic rainfall patterns.¹³ World Bank Group research has shown that catastrophic events have led to drops in household consumption per capita, compelling individuals to decrease calorie consumption, sell vital assets, work longer hours and pull children out of school (Baez et al. 2013). The adverse impacts of disasters may also disproportionately affect women, who often experience higher rates of mortality, morbidity and diminished earnings (World Bank 2012c).¹⁴

Poverty rates are particularly sensitive to changes—both positive and negative—in labor income, employment and remittances. During the period of inclusive growth between 2003 and 2008, rising employment among both men and women drove poverty reduction. Increases in female employment reduced moderate poverty by 2.4 percentage points and extreme poverty by 2.5 percentage points, while increasing male employment was associated with 3.2 and 3.3 percentage-point reductions in moderate and extreme poverty, respectively (figure 2.10). Remittances also contributed to poverty reduction during this period, cutting moderate poverty by 1.3 percentage points and extreme poverty by 2.1 percentage points. However, during 2008–12, a reduction in employment in Honduras coincided

with a weakening US labor market, leading to a simultaneous drop in both labor income and remittances. The reduction in remittances alone increased moderate and extreme poverty by 2 and 2.3 percentage points, respectively. However, falling male labor income consistently increased poverty over the entire period, raising the poverty rate by 3 percentage points in 2003–08 and by 4 percentage points in 2008–12.¹⁵

Before 2012 income growth was the key determinant of poverty trends; however, changes in income distribution played a dominant role in poverty reduction in 2013. A decomposition analysis can shed light on the relative contribution of income growth and income distribution to changes in poverty rates, along with the role of prices (figure 2.9).¹⁶ Gains in overall poverty reduction achieved prior to 2008 were mainly due to income growth supported by a modest improvement in the distribution of income, though these gains were mitigated by higher prices. This situation was reversed between 2008 and 2012, when weakening economic growth and an increasingly unequal distribution of income pushed poverty rates up, while price changes partially offset this effect. By contrast, almost all poverty reduction observed in 2013 has been attributable to improvements in the income distribution.

Job and wage growth in manufacturing, construction and agriculture contributed to poverty reduction prior to 2008, while declines in those same sectors caused poverty to rise after 2008. Increased earnings from manufacturing reduced the poverty rate by 2.2 percentage points between 2003 and 2008, whereas construction and agriculture contributed 1 and 1.5 percentage points, respectively (figure 2.11). Conversely, during 2008–12 declining earnings in these sectors increased poverty. Manufacturing contributed the largest share, accounting for 1.4 percentage points of the increase in poverty.

FIGURE 2.10 Remittances and Labor Income Have Been Key Factors in Poverty Reduction
(Poverty reduction by income source, 2003–13)



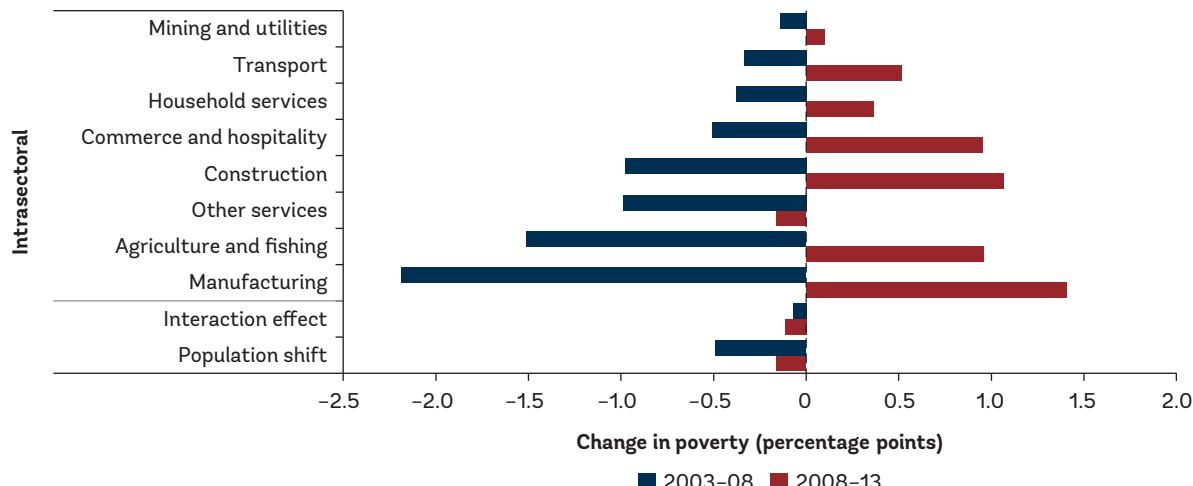
Source: World Bank estimates based on EPHPM.

Social Assistance Programs

The expansion of social assistance programs has had a modest but positive impact on extreme

FIGURE 2.11 Fluctuations across Sectors Contributed to Changes in Poverty before and after 2008

(*Huppi-Ravallion decomposition 2003–08, 2008–13*)

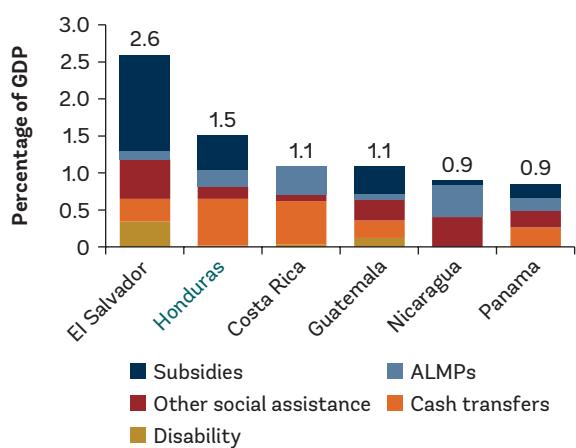


Source: World Bank estimates based on SEDLAC (CEDLAS and the World Bank).

Note: The figure is the result of the Huppi and Ravallion (1991) decomposition of labor income poverty. The decomposition calculates the change in poverty that is due strictly to changes in labor income. This approach abstracts from the effects of changes in non-labor income, such as public transfers or pensions. To accomplish this, changes in poverty are calculated using labor income poverty rates—the proportion of households with labor income of less than US\$4 per day per capita. The intrasectoral component refers to the sector of employment of the main earner in the household.

FIGURE 2.12 Cash Transfers Are an Important Part of Social Programs in Honduras

(*Social programs in Central America, in % of GDP, 2012*)



Source: World Bank 2015b.

Note: ALMPs stands for Active Labor Market Programs.

poverty over the past decade. In recent years these programs have proliferated throughout the region (figure 2.12). Honduras' *Bono Vida Mejor* (formerly *Bono 10,000*) is a conditional cash transfer (CCT) program designed to incentivize

child healthcare and school attendance (box 2.3). The *Bono* is relatively well-targeted compared with other interventions in the country and with other CCT programs in Central America, though substantial coverage gaps among the extreme poor remain. Estimates for 2013 show that 75 percent of beneficiary households are extremely poor.¹⁷ Only 14.4 percent of beneficiaries are in the top two quintiles. This is in line with other CCT programs in the region and compares well with other social assistance programs in Honduras. Since 2013, the *Bono* has improved its targeting to the extreme poor. Improvements in targeting and coverage will also be critical to improving the country's other social assistance and subsidy programs.

The *Bono* has reduced poverty among its beneficiaries while increasing primary school attendance and demand for health services in program areas. A 2013 impact evaluation found that the program had reduced the overall poverty rate among beneficiaries from 88.8 percent to 83.8 percent, and the extreme poverty rate from 73 percent to 63.7 percent (figure 2.13).

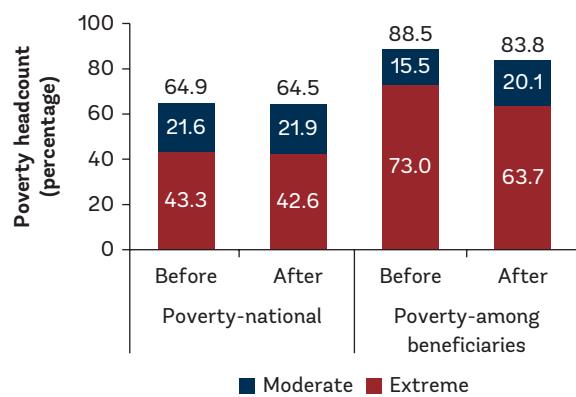
BOX 2.3 Improvements in Honduras' CCT System

In 2010 the Government launched a national consolidated conditional cash transfer (CCT) program, *Bono 10,000*, which rapidly became the country's main social assistance vehicle. Its annual funding was equal to 0.7 percent of GDP (US\$ 130 million), and by 2013 the program reached almost 20 percent of the population, including 270,000 rural households and 50,000 urban households. Before 2009 the Government had operated two CCT programs that provided income transfers to extreme poor rural households in extreme poverty: *Bono Solidario*, which encouraged regular health checkups for infants, and *Bono Escolar*, which promoted primary school enrollment among children aged 6–13. *Bono 10,000* consolidated these programs and expanded its targeting to include both extreme and moderately poor families with children under the age of 5 or in primary school. The program paid a benefit of 10,000 lempiras (US\$500) per year to its beneficiaries, ranking it among the most generous CCT programs in the world.

In 2014 the CCT program, now called *Bono Vida Mejor*, was enhanced, and it became the core intervention of the government's social development strategy, *Estrategia Vida Mejor*. To improve the fiscal sustainability of the program, the targeting formula was revised to restrict eligibility to beneficiary families classified as extremely poor. Coverage was expanded to students in lower secondary school to address the country's relatively high dropout rate. Benefits are now based on the number of eligible children in the household and capped at 10,000 lempiras. The program's expansion prioritized areas that (a) had high rates of extreme poverty, (b) were prone to severe droughts, (c) were home to indigenous communities, and (d) suffered from a high child incidence of child migration during the recent surge in undocumented child migrants leaving for the US. The program is still evolving and the government is keen to strengthen the institution that executes the program.

FIGURE 2.13 *Bono Vida Mejor* Has Reduced Poverty among Its Beneficiaries

(Poverty impact, nationally and among beneficiaries, 2012 and 2013)



Source: World Bank calculations based on EPHPM and using ADEPT SP software.

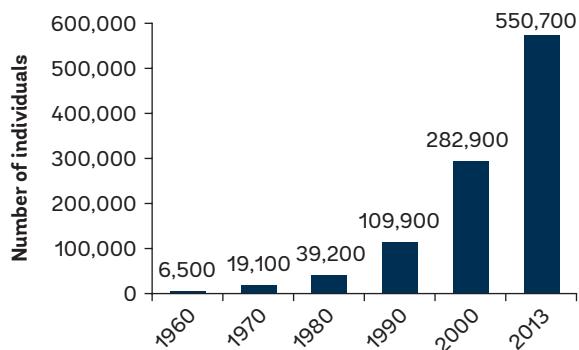
Among rural beneficiaries the poverty rate fell by 3.1 percentage points, while per capita consumption increased by 7.8 percent. Simulations of the recent improvements in targeting and reduction in benefits suggest a potential reduction in the

national extreme poverty rate of 1.7 percentage points. The impact evaluation also revealed that primary school enrollment in program areas had increased by 3.1 percentage points, and attendance rose by 3.5 percentage points. While child visits to health centers increased by 4.1 percentage points in program areas, the evaluation did not find a significant correlation with nutritional outcomes, vaccinations or prenatal care.¹⁸

Migration and Remittances: A Complex Relationship

Over the past 15 years, migration and remittances have come to play an increasingly important and complex role in the Honduran economy. As of 2013, an estimated 8 percent of Honduran nationals were living outside of Honduras, including as much as 13 percent of the working-age population.¹⁹ There were over half a million Honduran-born immigrants living in the U.S. in 2013, representing over 80 percent of Hondurans living abroad (figure 2.14).²⁰

FIGURE 2.14 Honduran Emigration to the United States Has Grown over the Past Several Decades
(Honduran immigrants in the US, 1960–2013)



Source: World Bank estimates based on Migration Policy Institute database (using US Census and ACS data).

Large-scale migration to the US and elsewhere has accelerated rapidly in recent years; over 25 percent of Honduran migrants in the US arrived after 2006, and migration grew at an average rate of 5.2 percent per year between 2000 and 2012. Recent emigrants have lower levels of educational attainment than earlier cohorts, suggesting that emigration is increasingly common among the less well-off (box 2.4). An estimated 60–77 percent of Honduran immigrants in the US are undocumented,²¹ and a lack of legal status limits their earnings potential. Even so, remittances skyrocketed in the years prior to the global financial crisis, rising from less than US\$1 billion in 2000 to US\$2.8 billion in 2008. Remittances fell to US\$2.47 billion in 2009 as the crisis weakened

BOX 2.4 Characteristics of Migrants

The first significant wave of Honduran migrants to the United States left in the aftermath of Hurricane Mitch in 1998. After the hurricane devastated much of the country, Honduran immigrants were granted Temporary Protected Status (TPS) by the US government, granting them work authorization and protection against deportation. Even though the TPS only applied to those arriving before the end of 1998, increasing numbers of Hondurans continued to migrate to the US. Today, the majority of the Honduran-born population in the US is undocumented.

In recent years Honduran migrants have become increasingly bimodal in terms of their education and skill levels, revealing the changing dynamics that motivate and facilitate migration. Since 2010 Honduran migrants have become more likely to have either a primary education or less, or a completed secondary education or more. Whereas those with an incomplete secondary education accounted for more than half of post-Mitch migrants, they accounted for just one in ten adult migrants after 2010 (figure B2.4.1). The job profiles of Honduran immigrants have also changed: prior to 2000, only 25 percent of Honduran migrants worked in construction or food service, but by 2010 this share had doubled. These patterns reflect increasing emigration by poorer Hondurans. This is confirmed by the change in the distribution of receipt of remittances observed between 2003 and 2013. In 2003, the bulk of remittances went to the top quintile, but most now go to the middle quintiles.

Recent Honduran migrants to the US are younger on average and include more children. While in the initial wave, approximately 80 percent of migrants were 25 or older, this age group accounted for 70 percent of those arriving in the US between 2010 and 2013; instead, more than a quarter of migrants were 15 or younger during this period, suggesting more family migration and reunification.

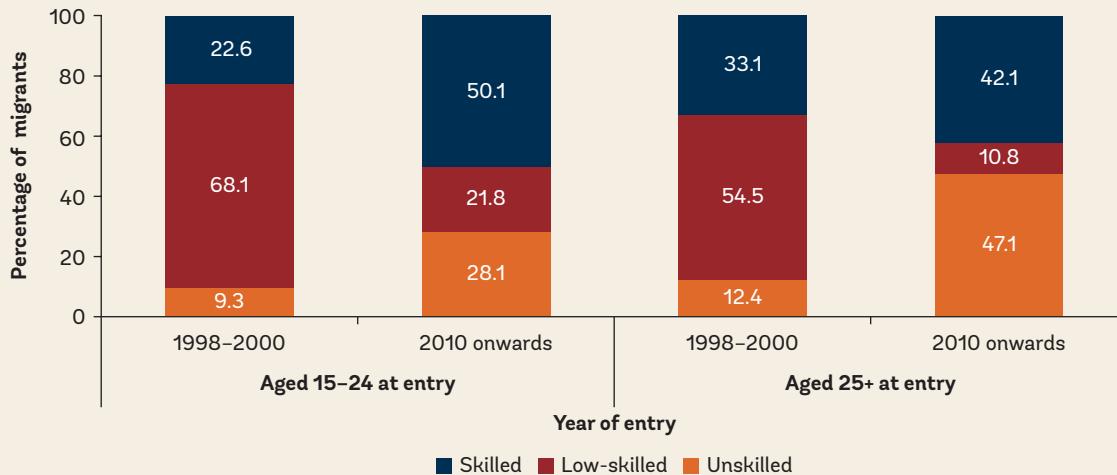
The recent surge in child migrants to the US has led to a joint effort with El Salvador and Guatemala to address the structural causes of migration. Fleeing poverty, lack of opportunity and some of the highest crime rates in the world, the number of unaccompanied minors from Honduras detained at the

box continues next page

BOX 2.4 continued

FIGURE B2.4.1 There Has Been an Increase in Unskilled Migration from Honduras in Recent Cohorts

(Educational attainment of Honduran migrants at age of entry, 1998–2000 and 2010–13)



Source: American Community Survey (ACS) 2013 and 2000 US Census.

Note: Information for the most recent arrival cohort (2010 onwards) are from the ACS 2013 while information from the post-Mitch cohort (1998–2000) are from the 2000 US Census. The figure presented breaks workers into three skill levels: the unskilled, who completed primary schooling at most (including those with no formal schooling); the low-skilled, who completed some secondary education; and the skilled, who have at least a secondary-school education.

US-Mexico border rose from fewer than 7,000 in 2013 to over 18,000 in 2014, creating an international humanitarian crisis.^a In 2015 Guatemala, El Salvador and Honduras proposed the “Plan of the Alliance for the Prosperity of the Northern Triangle” to expand economic opportunities and develop human capital. The crisis at the border has triggered increased interest and investment in the region, including a US-sponsored US\$1 billion “Plan for Central America” to support the tripartite strategy.

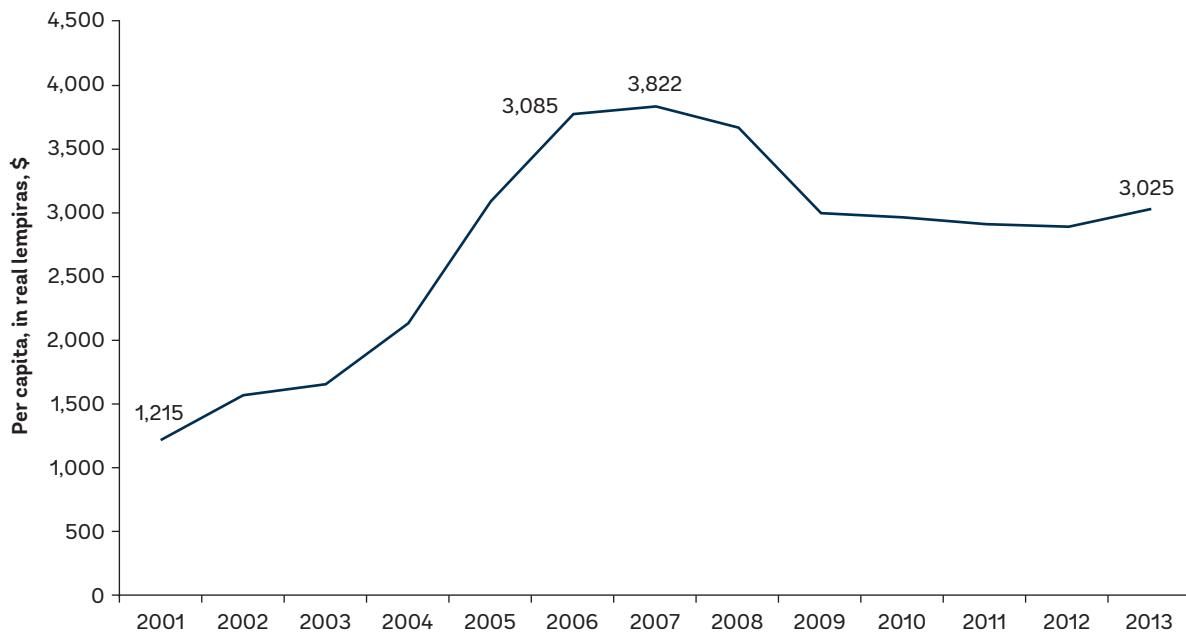
a. U.S. Customs and Border Protection (<http://www.cbp.gov/newsroom/stats/southwest-border-unaccompanied-children>); accessed June, 2015.

the US labor market, but then gradually recovered to US\$3.1 billion in 2013, equivalent to 17 percent of GDP. In real per capita terms, however, they are yet to return to their pre-crisis value (figure 2.15).

Remittances have become increasingly pro-poor and have decreased poverty rates. There is evidence that remittances in Honduras have led to poverty and inequality reductions.²² Between 2003 and 2008 remittances contributed to falling poverty rates, but the drop in remittances following the global financial crisis increased poverty from 2008 to 2012 (figure 2.10).

Remittances are increasingly important to households at the lower end of the income distribution, reflecting changing demographics of Honduran migrants (box 2.4). In 2013, they represented just over 20 percent of per capita household income among households in the bottom two quintiles, up from just 8 percent in 2003. The share of poor households that receive remittances also more than doubled in the last decade, rising from 1.7 percent to 3.4 percent for households in the lowest quintile and from 3.4 percent to 7.3 percent for households in the second-lowest, while the share of

FIGURE 2.15 Remittances Rose Substantially in the Years before the 2008/09 Crisis
(Per capita remittances in real lempiras, 2001–13)



Source: World Bank estimates based on data from the Honduran authorities.

BOX 2.5 Analyzing the Determinants of Remittances in Honduras

Although external factors are the most relevant explaining changes in remittance flows to Honduras, domestic factors are also important. A time-series Vector Autoregressive Regression (VAR) analysis conducted for this SCD finds that, in line with findings in the literature, the economic cycle in the U.S. is the most important factor explaining changes in remittance flows to Honduras: almost 40 percent of the variation in remittance flows is explained by U.S. economic activity. Similarly, a deterioration of employment among Honduran workers in the U.S. is associated with weaker remittance flows back home. Conditions in global financial markets and the stance of monetary policy in the U.S. also appear to influence remittance flows. But not everything is external, as Honduras' GDP explains around 25 percent of the variability in remittance flows. Higher economic activity in Honduras implies a greater demand for labor and higher wages, as well as an increase in wealth. Hence, as GDP growth in Honduras accelerates, the demand for non-labor income falls and so remittances decrease.

households in the richest quintile receiving remittances fell from 8.2 percent to 4.3 percent. Among households in the first two quintiles that received remittances, those remittances represented almost half of their income (48.9 and 49.2 percent, respectively) in 2013. Children from families reporting remittances are more likely to stay in school and enrollment

rates are approximately 12 percent higher for those aged 12–17.²³

While migration and remittances have become important contributors to household income and poverty reduction in Honduras, and can help insulate households against domestic volatility, their macroeconomic implications can exacerbate poverty and increase

household income volatility. As discussed in chapter 3, remittances can erode international competitiveness and slow the pace of job creation. Dependence on remittances can also exacerbate external vulnerability, as it ties household income to trends in foreign labor markets (box 2.5). For example, the sharp decline in remittances following the global financial crisis contributed to rising poverty rates in Honduras, underscoring the vulnerability of poor households to external shocks.

Similarly, exchange-rate fluctuations can impact the real value of remittances.²⁴ However, remittances can also stabilize consumption against domestic shocks. The sensitivity of remittances to growth in Honduras suggests that they may be part of household strategies to cope with local economic trends and smooth consumption over time. Finally, with limited access to credit and insurance markets, migration and remittances may serve as an insurance strategy for low-income households.²⁵

Notes

1. Internationally comparable moderate and extreme poverty are measured US\$4 and US\$2.50 per day in 2005 purchasing-power parity terms.
2. Comparable extreme poverty data are available for 18 LAC countries. These data exclude most Caribbean countries, as well as Republica Bolivariana de Venezuela. Poverty rates for Haiti, Guatemala and Nicaragua are from 2012, 2011 and 2009, respectively.
3. Statistically, stunted children complete one fewer year of school than non-stunted children, and stunted adults earn 20 percent less than non-stunted adults (M. Shekar 2014).
4. Only 31 percent of children under 6 months of age are exclusively breastfed, and on average children in this age group are only exclusively breastfed for 2.5 months instead of 6 months (ENDESA2010/11).
5. Per capita income has been adjusted for 2005 purchasing power parity.
6. It is the highest out of the 17 LAC countries with comparable inequality measures.
7. See box 2.2 for international benchmarking of inequality.
8. World Bank estimates based on SEDLAC (CEDLAS and the World Bank).
9. For international comparability “middle class” is defined as having a daily per capita income of between US\$10 and US\$50.
10. See *Latinobarometro Honduras*, 2013.
11. A synthetic panel was constructed based on Dang et al. 2014. Measures of poverty taken at one point in time, or even multiple points in time provide little information on intra-generational mobility. Honduras does not collect the panel data required to follow individuals over time. However, a methodology that simulates panel data was applied to household surveys in Honduras for 2003, 2007 and 2011 to look at movements into and out of poverty using the international poverty line of US\$4 per capita per day. See World Bank (2015a).
12. This is corroborated by sharper falls in the poverty gap indicator for the rural population than for the urban population (18.3 percent versus 15.5 percent reduction) between 2003 and 2013, indicating that the poor in rural areas, while still poorer than those in urban areas, saw their incomes rise faster. The poverty gap measures the distance between the income of those living in poverty and the income needed to exit poverty (\$4/day). World Bank estimates using SEDLAC (CEDLAS and the World Bank).
13. The probability of disasters also affects people’s perceptions of uncertainty, disrupting their normal decision making. Disasters have the potential to destroy part of the capital stock and impair productivity; thus they are characterized by declines in investment, corporate leverage, output, and employment, and account for part of increased risk premium in financial markets.
14. Several underlying factors exacerbate women’s vulnerability to the impacts of disasters, such as lack of means to recoup lost assets, limited livelihood options, restricted access to education and basic services, and in many cases, also socio-cultural norms.
15. Due to how the decomposition is calculated, men’s falling labor income may be due to fewer men in the household (resulting from increased out-migration, for example) rather than falling wages. Additional analysis reveals a small increase in the average wage of men during the three periods while the share of the male share of the adult population fell slightly.
16. The price level effect captures changes in the poverty line due to changes in the price of the

- basket of goods rather than changes in the income of households. This is important for official poverty lines as they are not based on a constant monetary line but rather on the cost of a constant basket of goods.
17. World Bank calculations based on 2013 EPHPM and using ADEPT SP software.
 18. One possible explanation could be the insufficient supply of health services in rural areas. Increase in nutritional outcomes is also typically challenging since they are a result of multiple factors—water, sanitation, food, practices, etc.
 19. World Bank estimates based on KNOMAD migration data and 2013 American Community Survey.
 20. Estimates based on Migration Policy Institute and KNOMAD data.
 21. Pew Research Center estimates for 2005–12 based on augmented American Community Survey data from Integrated Public Use Microdata Series (IPUMS).
 22. Acosta et al. (2008) estimate that in 2002 remittances decreased the Gini coefficient in Honduras by 1.1 percent and moderate poverty by 0.37 percent for each 1 percentage point increase in the remittances to GDP ratio. In addition, the study finds that remittance recipients in Honduras are more likely to be found among highly educated individuals, and remittances income is distributed more unequally than total income.
 23. Acosta et al. (2008) using the 2007 Honduran household survey.
 24. For example, in the case of the Philippines (Yang 2008).
 25. Relying on data from the Philippines, Yang and Choi (2007) estimate that about 60 percent of exogenous falls in household income were replaced by remittance inflows. As a result, households with access to remittances did not see their consumption fall, while similarly affected households without remittances saw significant consumption effects. Clarke and Wallsten (2004) find that remittances were similarly used as insurance in Jamaica, where they replaced 25 percent of damages from Hurricane Gilbert in 1992; The World Bank has also found that remittances increased following natural disasters in Bangladesh, the Dominican Republic, Haiti and Honduras (Acosta et al. 2008). Using data for 26 LAC countries, Acosta et al. (2008) find that remittances are largely countercyclical, responding to reductions in real output below trend with more than a proportional increase.

Chapter 3

Economic Growth in Honduras: Challenges and Opportunities

Over the past 30 years, Honduras has experienced modest economic growth marked by considerable volatility. Meanwhile, economic growth has not kept pace with rapid population growth, preventing Honduras from converging with high-performing countries in Central America and elsewhere in the LAC region. External macroeconomic vulnerability, exposure to natural hazards, and a history of fiscal instability have repeatedly erased years of progress in raising incomes and reducing poverty, contributing to a set of mutually reinforcing vicious cycles that have trapped the country in a low-growth equilibrium. The Honduran economy's small size and high degree of external openness, its large agricultural sector, its sensitivity to exogenous shocks, and the presence of both chronic and emerging challenges to competitiveness have inhibited diversification, thereby undermining productivity growth and preventing the private sector from sustaining robust job creation in high-value sectors. A burdensome regulatory structure and capacity constraints, limited investment spillovers, inadequate infrastructure, low access to capital, a troubling rise in crime and violence, and large emigration flows not only slow overall growth but also narrow the distribution of its returns. Opportunities for sustained growth may come from the demographic dividend associated with the increasing labor force, provided the private sector is able to generate high-productivity jobs sufficient to accommodate the growing workforce.

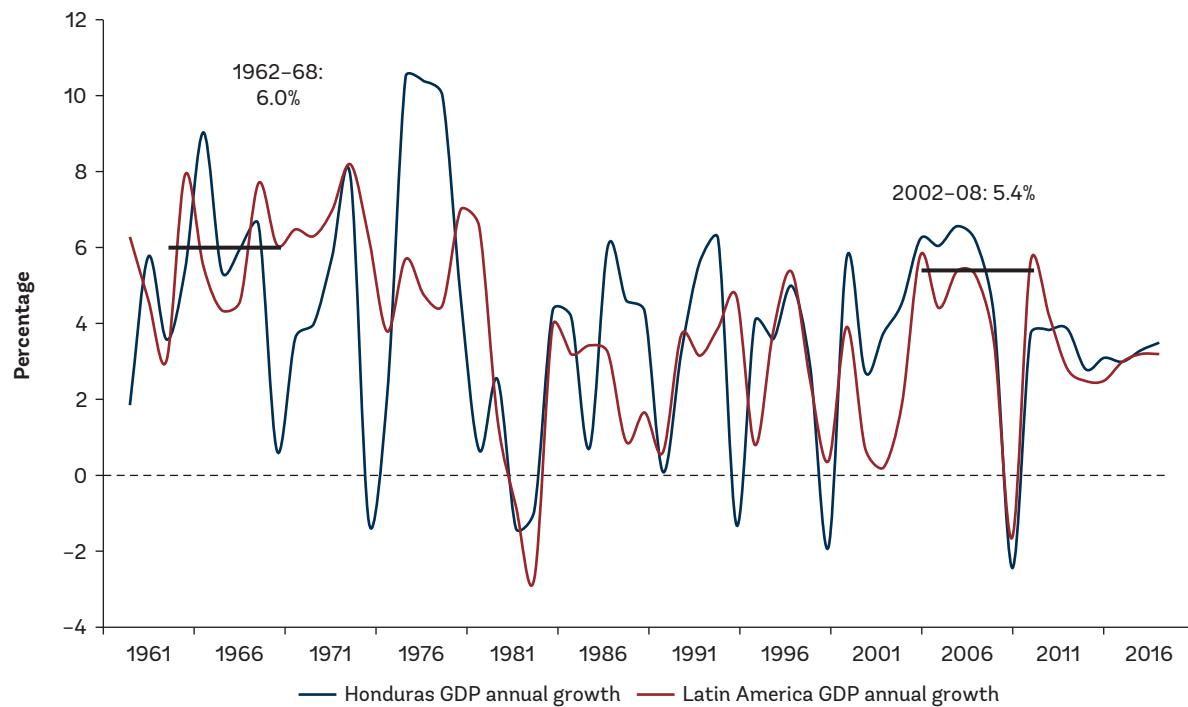
Decades of modest, highly volatile economic growth, combined with a rapidly expanding population, has resulted in slow, uneven improvements in gross domestic product (GDP) per capita. Over the past 30 years, Honduras' average annual real GDP growth rate (3.6 percent) exceeded both the LAC average (3.4 percent) and the global average (2.9 percent) (figure 3.1).

Yet during the same period Honduras' population grew at an annual average rate of 2.4 percent per year, far higher than the LAC average of 1.6 percent and on par with the average for Sub-Saharan Africa of 2.7 percent (figure 3.2). An increase in the size of the labor force has the potential to yield a demographic dividend. However, this will be contingent on the ability of the private sector to generate a sustained increase in high-productivity jobs sufficient to accommodate the growing workforce. If job growth is inadequate or confined to low-productivity sectors, demographic trends may further depress wages and contribute to negative economic and social outcomes.

While periods of robust growth have generated important gains in productivity, employment and poverty reduction, persistent volatility has repeatedly erased these gains, lowering Honduras' long-term growth trajectory and exacerbating poverty and inequality. Between 1960 and 2014 there were only two periods in which economic growth was sustained for more than five consecutive years. Growth in Honduras has occurred in a series of fits and starts, and since the mid-1970s, year-on-year growth has varied by more than 80 percent in almost half of all years, a degree of volatility that exceeds global, LAC and Central American averages.¹ Natural disasters and global economic shocks have had a major impact on Honduras' growth performance, while a combination of weak institutional capacity and limited fiscal space have hindered efforts to build resilience (box 3.1).

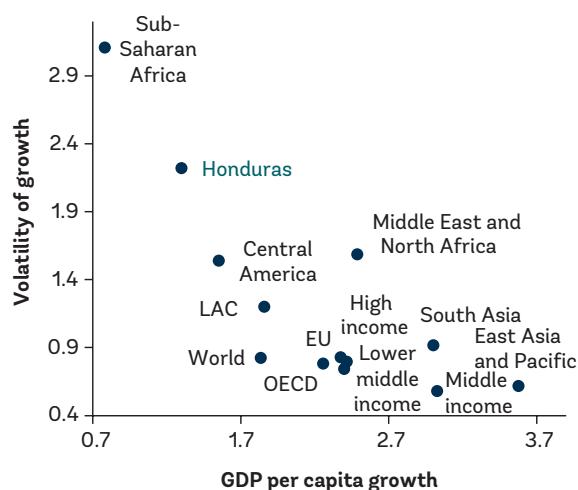
Honduras' low per capita growth rates have prevented it from converging with high-income countries or top performers in LAC. In 1960 Honduras' per capita income (in current US\$ terms) was equal to 13.5 percent of the average

FIGURE 3.1 Growth in Honduras Has Been More Volatile than the LAC Average
Average annual GDP growth in Honduras and comparators, 1961–2016



Source: World Development Indicators and World Bank estimates.

FIGURE 3.2 Growth in Honduras Has Been More Volatile than in All Other Regions Except Sub-Saharan Africa
Growth volatility and per capita GDP growth rates, regional averages, 1961–2013



Source: World Development Indicators and World Bank estimates.

for high-income countries (as defined by the World Bank) and 5.6 percent of US per capita income. In 2014, these same indicators fell to 6.2 percent and 4.3 percent, respectively. In other words, rather than converging with wealthier countries over time, Honduras has been diverging from them, with most of this divergence occurring between 1960 and 1990 (figure 3.3).

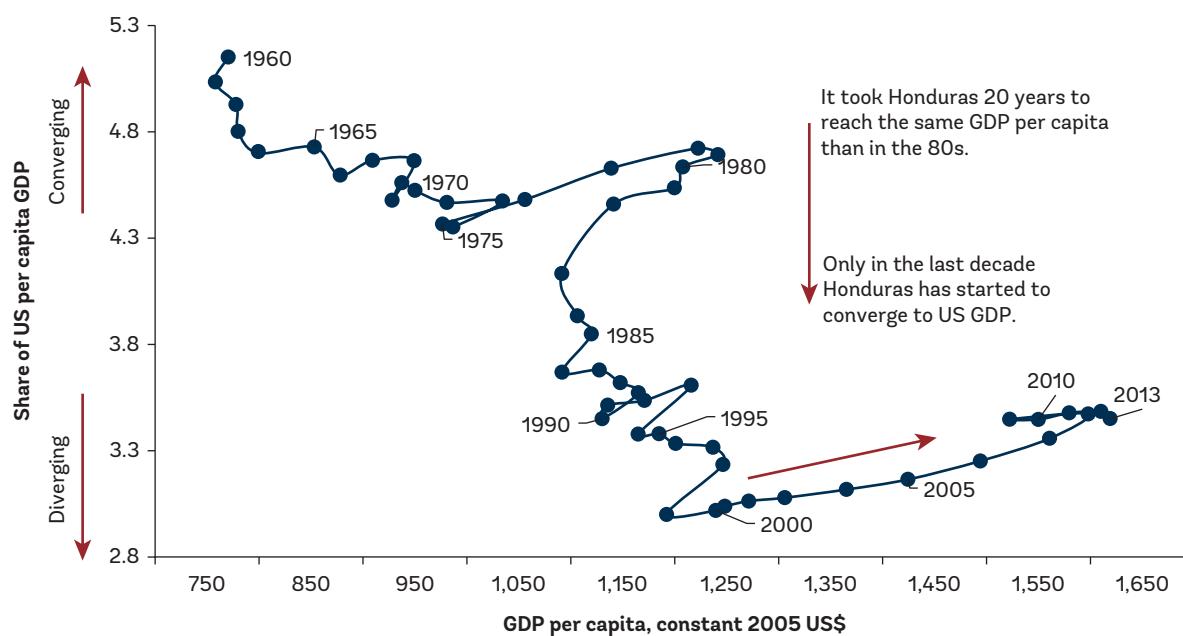
External and domestic shocks have repeatedly erased gains in poverty reduction, and post-crisis recoveries are often far less progressive than pre-crisis expansions. There have only been two periods in the past two decades in which poverty has fallen for three or more consecutive years, and both were periods of robust growth (figure 3.4). However, each period ended with a sharp contraction followed by multiple years of poverty increases. Between 1991 and 1994 GDP growth averaged 5 percent per year, and the poverty rate² fell by 10.8 percentage points; between 2006 and 2009 growth

BOX 3.1 Honduras' Exposure to Natural Hazards

Disasters associated with natural hazards, in particular climate-related events, have repeatedly derailed growth. Honduras' inherent vulnerability to natural hazards and climate change is an additional source of macroeconomic uncertainty. The country is highly exposed to hurricanes and tropical storms, mainly from the Atlantic, as well as dry periods associated with the *El Niño* weather cycle.^a Between 1994 and 2013 Honduras suffered the highest average annual economic losses due to climate-related disasters in Central America. During this period the cumulative impact of small-scale climate-related disasters (without taking into account damages from Hurricane Mitch) resulted in average economic losses of 2.5 percent of GDP per year (Global Climate Risk Index 2015). Hurricane Mitch, the worst disaster in Honduras' recent history, devastated the country in 1998, abruptly ending a period of economic expansion. It affected 90 percent of Honduras' territory, resulting in over 5,700 dead, 8,000 missing, and almost half a million people displaced (GFDRR 2010). It also destroyed more than 50 percent of the country's road infrastructure and 70 percent of its water network and damaged about 400,000 houses (ECLAC 1999). Subsequent extreme hydro-meteorological events since Hurricane Mitch suggest that Honduras' disaster vulnerability is on the rise. Most recently, eight tropical storms and hurricanes of various magnitudes had pronounced damages on the Atlantic coast with effects extending to the entire territory, notably Hurricane Felix in 2007, Tropical Depression Sixteen in 2008, and Tropical Depression 12E in 2011, which caused economic losses estimated at US\$ 200 million (ECLAC 2010).

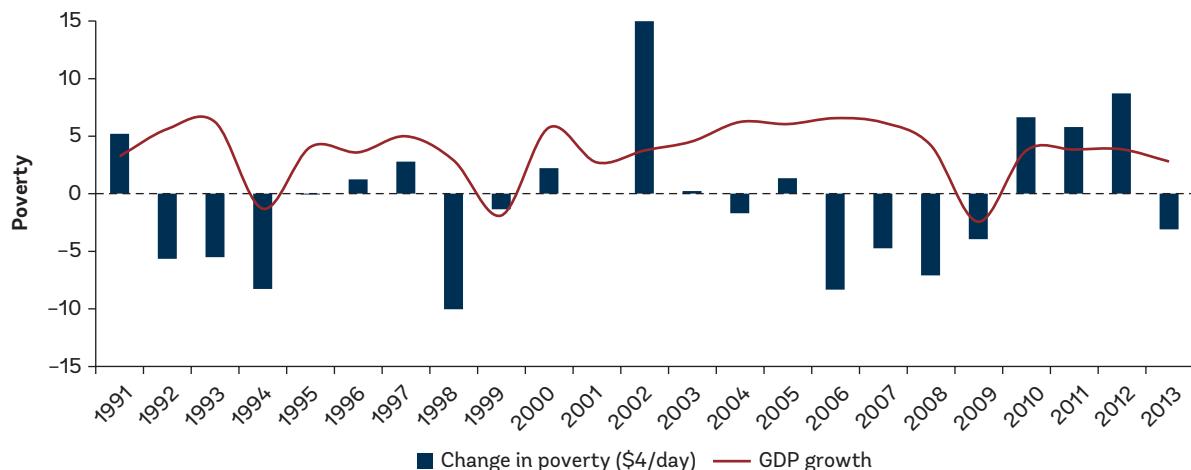
a. Honduras is also vulnerable to earthquakes, though in recent years only a single major earthquake has struck the country. Nevertheless, probabilistic risk models estimate losses associated with an event of a 500 year return period at approximately US\$2.2 billion, representing 6.3 percent of GDP, and an average annual loss due to earthquake equivalent to US\$ 35.5 million, or 0.103 percent of 2013 GDP (CCRIF SPC 2014).

FIGURE 3.3 The Growth Rate of GDP per Capita Has Been Both Low and Volatile
(*GDP per capita, in constant 2005 US\$ and as share of US GDP per capita*)



Source: World Development Indicators and World Bank estimates.

FIGURE 3.4 The Past Two Decades Saw Only Two Periods of Sustained Poverty Reduction
 (Annual GDP growth and poverty changes, 1991–2013)



Source: World Bank tabulations based on the World Development Indicators, SEDLAC (CEDLAS and the World Bank), and Honduran Authorities.
 Note: Poverty changes are based on US\$ 4 per day using 2005 PPP. Note that there is a break in the comparability of the poverty series in 2001, so the change in poverty rate is not reported for that year.

averaged almost 6 percent per year, and the poverty rate fell by 14.2 percentage points. The sharp downturns that ended each of these high-growth periods resulted in years of rising poverty, particularly the 2009 crisis, which completely reversed the progress made during the expansion. And while in each case poverty reduction resumed as the economy recovered from the shock, in neither case was this recovery sufficient to return the poverty rate to its pre-crisis low crisis.

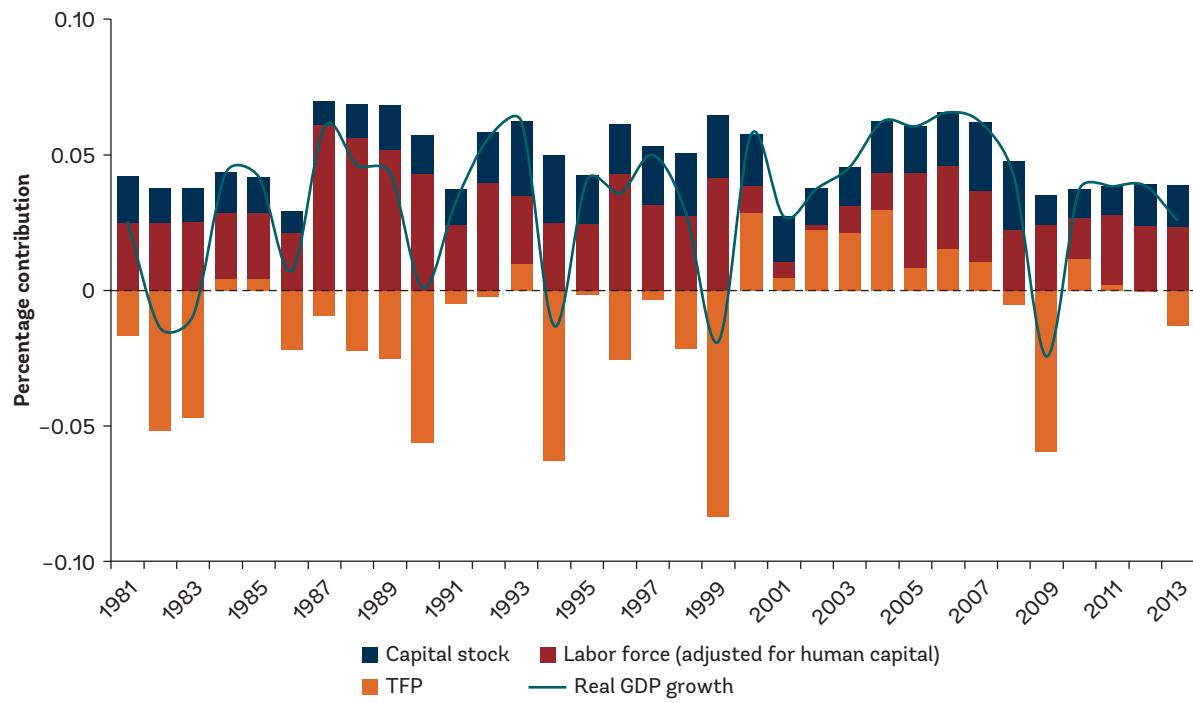
3.1 Drivers of Growth

Factor accumulation has been the primary driver of GDP growth, while the contribution of total factor productivity (TFP) has been almost uniformly negative. Growth accounting estimates based on a wide range of assumptions reveal a pattern of low and frequently negative rates of TFP growth combined with relatively high rates of physical and human capital formation. From 1981 to 2013 TFP contracted by an average of 1.1 percent per year (figure 3.5). This long period of negative TFP growth was not unique to Honduras, but the overall decline in productivity was more severe in Honduras than among most of its regional peers (World Bank 2011b).

Private consumption has reemerged as a key driver of growth. Prior to the 1990s, growth was led private consumption, supported by relatively modest rates of investment growth. From the early 1990s through the mid-2000s growth patterns shifted toward investment, boosted by reconstruction efforts following Hurricane Mitch and the rise of *maquila* industry. From 1990 through 2008, investment growth contributed an average 47 percent of GDP growth, up from only 3 percent in the 1980s (figure 3.6). Even though the investment rate in Honduras was consistently higher than in other countries with similar levels of per capita GDP, this did not translate into accelerated economic growth. In the wake of the 2009 crisis, aggregate demand again shifted toward consumption, supported by high inflows of remittances. Real investment declined, and as imports stagnated a gradual recovery in net exports supported growth.

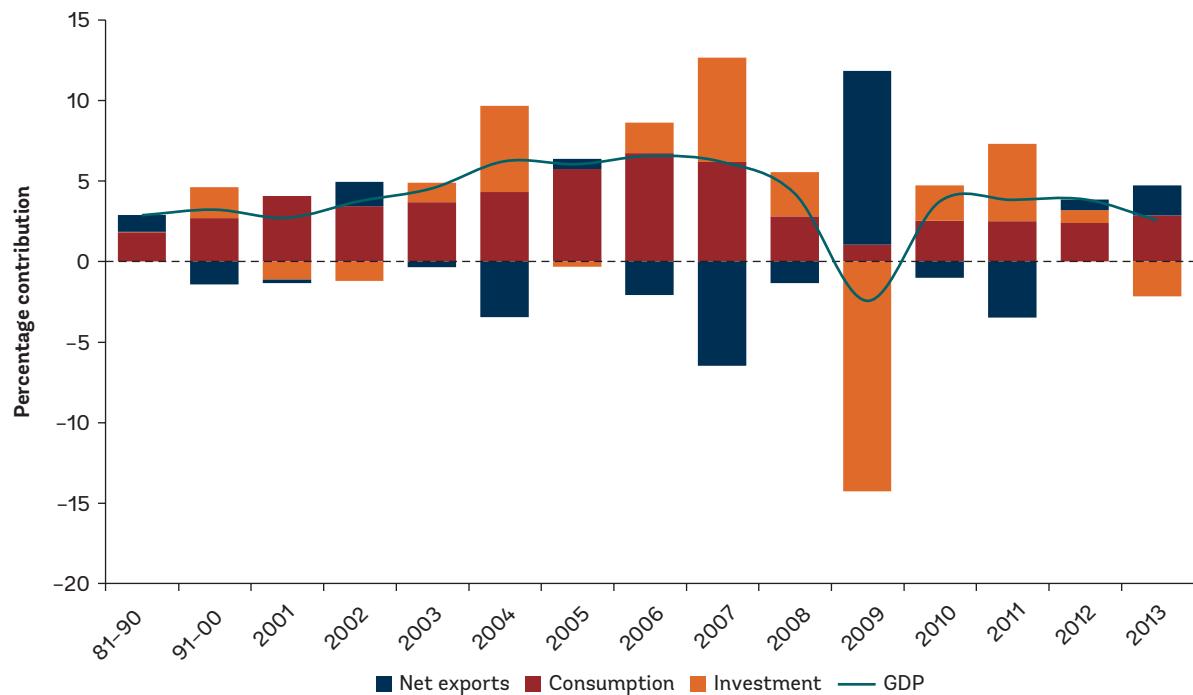
Labor's contribution to growth has occurred primarily through the expansion of the labor force rather than improvements in the marginal productivity of labor. Labor accumulation has accounted for roughly 2.2 percent of economic growth in recent years, as high fertility rates and increased life expectancy have caused the

FIGURE 3.5 Productivity Growth in Honduras Has Generally Been Negative
(Solow growth decomposition, 1981 to 2013)



Source: Honduran authorities and World Bank estimates.

FIGURE 3.6 Growth Is Being Driven by Private Consumption
(Growth decomposition by sources of aggregate demand, 1981 to 2013)



Source: Honduran authorities and World Bank estimates.

KNOWLEDGE GAP What Are the Determinants of Low Returns to Investment in Honduras?

Since the 1990s Honduras' investment-to-GDP ratio has been high by regional standards, yet productivity gains have been persistently low. This strong accumulation of capital was sustained throughout the period but did not result in higher productivity growth and hence faster economic growth. A majority of this investment is private, including substantial FDI inflows, with public investment making a limited contribution. However, in contrast to other countries Honduras demonstrates no significant positive correlation between the investment ratio and GDP growth. Capital accumulation has contributed an average of just 1.7 percentage points to GDP growth since the early 1980s. The reasons for the apparently low impact of investment on growth are not fully understood. Possible explanations may involve the sectoral allocation of investment or the high cost of doing business. Appendix E presents preliminary research on the relationship between investment and growth in Honduras.

labor supply to increase consistently for the past four decades.

Honduras' most recent period of robust pro-poor growth occurred during the global economic expansion of the mid-2000s. Between 2001 and 2008 strong simultaneous increases in labor, capital and TFP pushed Honduras' growth trajectory toward convergence with the developed world. Accelerating growth in the early 2000s was supported by large-scale investments in reconstruction following Hurricane Mitch. Meanwhile, the global economy entered a period of remarkable growth, and Honduras' high degree of trade openness left it well positioned to take advantage of rising commodity prices. Robust export revenues and high rates of investment supported an average growth rate of 5 percent per year for a full 8 years. This was the country's strongest performance since the early 1960s, and its growth rate exceeded the LAC average of 3.9 percent. Moreover, the returns to growth were clearly progressive, and both poverty and inequality indicators fell substantially during the period.

However, Honduras' robust growth came to an abrupt end in 2009, as the impact of the global financial crisis was exacerbated by domestic political instability, causing GDP to contract by 2.7 percent in a single year. The post-crisis recovery was slow and uneven, with growth averaging 3.3 percent over 2010–14.

TFP growth again turned negative, and labor and capital accumulation were the exclusive drivers of an anemic recovery. The contraction affected nearly all sectors of the economy, though export-oriented industries such as *maquilas* and tourism were hit the hardest. Turmoil in global financial markets curtailed investment and disrupted the construction sector, while worsening conditions in the US labor market caused a dramatic decline in remittances, which adversely affected retail and non-tradable services. A sharp decline in income at the top end of the distribution briefly reduced inequality, but the Gini coefficient soon began to rise as wealthier households recovered faster than their poorer counterparts. Poverty rates increased for three consecutive years, and though progress resumed in 2013, poverty remains well above its pre-crisis level.

3.2 Recent Job Growth Has Been Concentrated in Low-Productivity Sectors

During the strong growth period of the mid-2000s, the secondary and tertiary sectors drove a balanced pattern of job growth, and wages rose modestly as the economy diversified away from agriculture. From 2003 to 2008, as an expanding global economy supported robust export-oriented growth, Honduras' industrial,

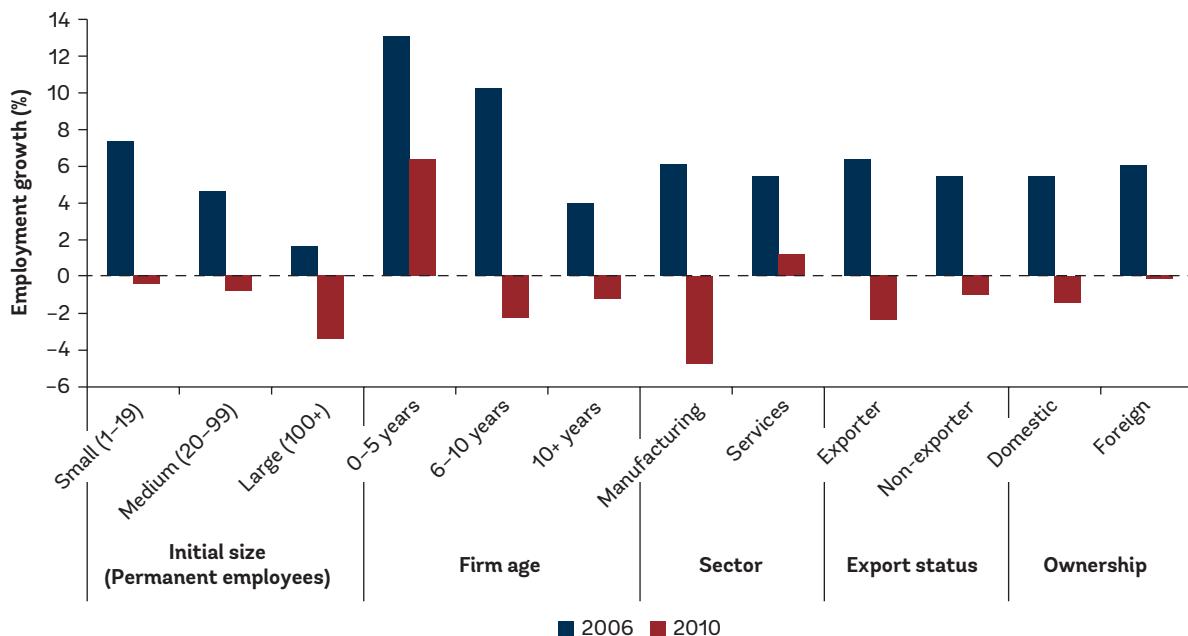
commercial and service sectors led job creation. Employment growth in the agricultural sector was positive, but far below the population growth rate. As the urban economy absorbed an increasingly large share of the labor force, wages rose among remaining agricultural workers.

Enterprise surveys reveal a steep decline in job creation in manufacturing following the crisis, and the importance on young and small firms to generate jobs both before and after the crisis (figure 3.7). In 2006, young firms (those 5 years old and under) reported employment growth of 13 percent on average, while small firms (those with less than 20 employees) reported 7.3 percent more jobs. Even in 2010, a year in which the private sector was still feeling the effects of the 2009 crisis, young firms were able to generate new jobs, though at a lower rate than in 2006. Enterprise surveys reveal that both exporters and non-exporters, as well as domestic and foreign-owned firms, created jobs at about the same rate in 2006. Yet, in 2010 domestic firms and those who were exporters reported a larger destruction of jobs. The crisis also had a large

impact on the manufacturing sector, where firms reported a reduction in employment of almost 5 percent on average. Even though small and young firms have been responsible for creating a disproportionate share of jobs, they face a number of challenges that impede their further growth, thereby affecting employment opportunities.

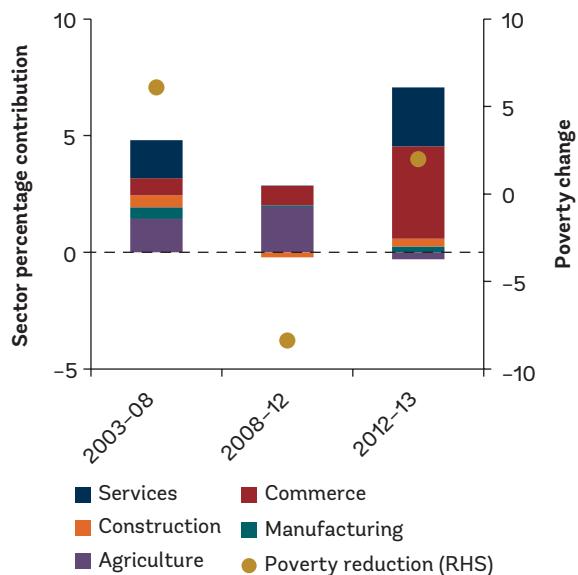
Most jobs created since the 2009 crisis have been in low-productivity sectors. The impact of the 2009 crisis radically altered the pattern of job creation (figure 3.8). Between 2009 and 2012, job growth ceased in the service sector, and the number of industrial jobs declined. Commerce continued to make a positive contribution, but it was not enough to accommodate the growth of the labor supply. As a result the agricultural sector absorbed a large share of excess labor, and the sudden influx of workers caused agricultural wage rates to plummet, wiping out the gains made during the middle of the decade (figure 3.9). Overall, since 2009, new job opportunities were mostly concentrated in less skill-intensive, less technologically sophisticated activities such as commerce (a sector with high rates of self-employment), hotels and

FIGURE 3.7 Young and Small Firms Are Responsible for a Larger Share of Job Creation
(Employment growth by firm characteristic, 2006 and 2010)



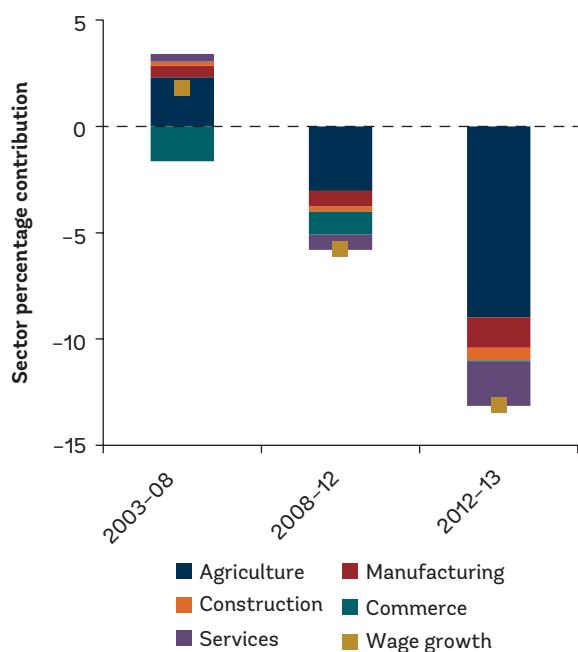
Source: World Bank tabulations using the Enterprise Survey, 2006 and 2010.

FIGURE 3.8 Patterns of Job Creation Changed Dramatically before and after the Crisis
(Jobs creation by sector and changes in poverty rate)



Source: World Bank estimates based on the EPHPM.

FIGURE 3.9 Wages Rose before the Crisis as Urban Growth Reduced the Rural Labor Supply
(Wage growth by sector)



Source: World Bank 2015b.

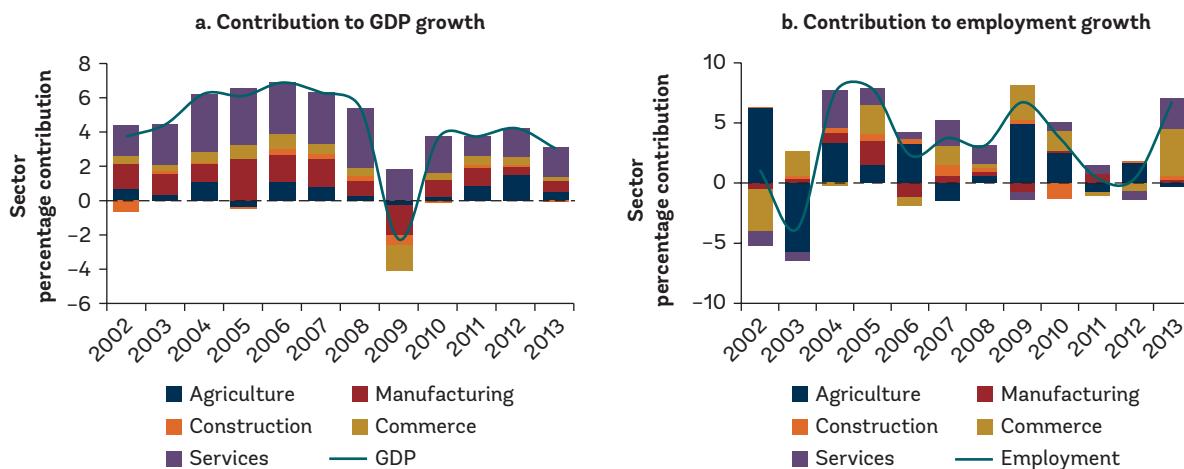
Note: The category "other" is primarily made up of unpaid family workers.

restaurants, rather than higher-value-added sectors like manufacturing, telecoms and finance. Agriculture was the second largest source of employment creation and accounted for roughly 40 percent of new jobs, particularly in the coffee and palm oil industries. However, this increase was not driven by demand for more agricultural labor, but rather by an excess supply of workers who turned to agriculture as an employer of last resort. Manufacturing was a key driver of job creation in the pre-crisis period, but its recovery has been weak due to challenges in the *maquila* sub-sector, as described further in the next section.

Poverty rates fell fastest during periods when high-value-added sectors contributed the most to job creation. During the mid-2000s the poverty rate declined by 6 percentage points, as labor incomes increased. During the 2003–08 period the main contributors to job creation were manufacturing, telecommunications and finance. However, during 2008–12, as poverty rates rose, job creation was driven by the low value-added commerce and agriculture sectors, while manufacturing and services largely stagnated (figure 3.10). These were also years in which the agricultural sector suffered from an outbreak of rust leaf disease in coffee production, hurting output. From 2012 to 2013, when poverty reduction resumed, job creation was still driven predominantly by the low value-added commerce sector, but it was accompanied by a modest but rising contribution from manufacturing and other services and a slight reduction in agricultural employment. These trends suggest that the creation of jobs in higher value-added sectors is closely linked to poverty trends.

The concentration of job growth in low-productivity sectors has caused a range of negative labor market outcomes. Honduras has one of the lowest labor force participation rates in the region. The labor force participation rate among adults age 25–54 is just 72 percent, well below the LAC average of 81 percent. While Honduras' overall unemployment rate of 6 percent is not exceptionally high by international standards, it is elevated by the standards of regional comparators, particularly El Salvador, which recorded an

FIGURE 3.10 Sectoral Growth Patterns Are Consistent with Employment Patterns



Source: Honduran authorities and the World Bank estimates.

Note: Manufacturing sector includes utilities and mining. Services sector includes transport and communications, financial services and other services.

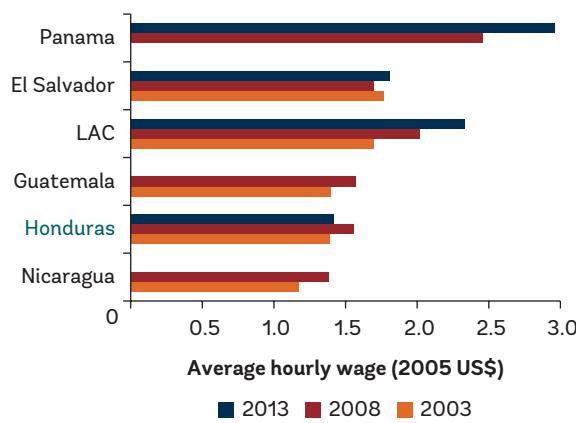
unemployment rate of just 3.8 percent in 2013. Furthermore, the unemployment rate has been growing since the 2009 crisis. Salaried employment represents fewer than half of all jobs in Honduras, and self-employment accounts for 41 percent of total employment, the highest share in Central America (figure 3.12). Self-employment has been the main driver of recent job growth, accounting for 212,000 of the 230,000 jobs created between 2011 and 2013.

Honduran workers continue to earn less than the LAC average, and the wage gap has grown over the past decade (figure 3.11). In 2003, the average worker in Honduras earned approximately \$1.39 per hour, compared to a regional average of \$1.70. By 2013, the average wage in Honduras had grown by just 2 percent, while the regional average had grown by 37 percent. The average hourly wage in the LAC region reached \$2.33 in 2013. Low average wages hide significant wage gaps between different types of workers.³

Persistently low levels of labor productivity have suppressed wage growth across the Honduran economy. Agricultural workers, who account for 57 percent of the extremely poor, are the least productive in the economy, and the agricultural sector has registered only small gains in labor productivity in recent years (figure 3.14). However, in even

FIGURE 3.11 The Gap between Average Real Wages in Honduras and the Region Grew between 2003 and 2013

(Average hourly wage rates, Honduras and comparators, 2004, 2008, 2013)

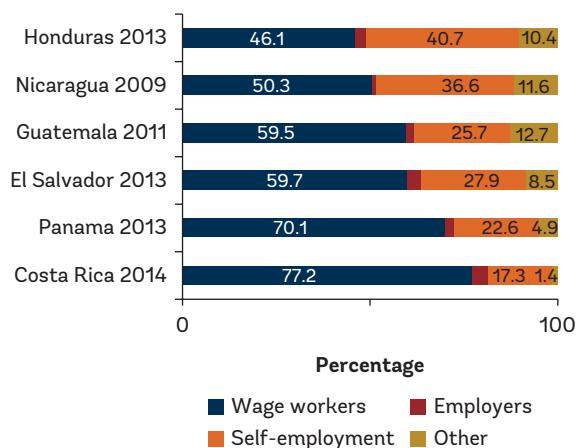


Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank).

Note: Wages are reported as average hourly wages adjusted to 2005 US using 2005 purchasing power parity. Average wages are calculated for all workers age 18–65 who are not classified as unpaid workers.

the more productive manufacturing and service sectors, marginal output remains well below the LAC average (figure 3.13). Due to low and stagnant labor productivity most poor households can only increase their labor income by extending their total working hours.

FIGURE 3.12 Self-Employment Accounts for 4 Out of 10 Jobs in Honduras
(Employment by type, circa 2013)



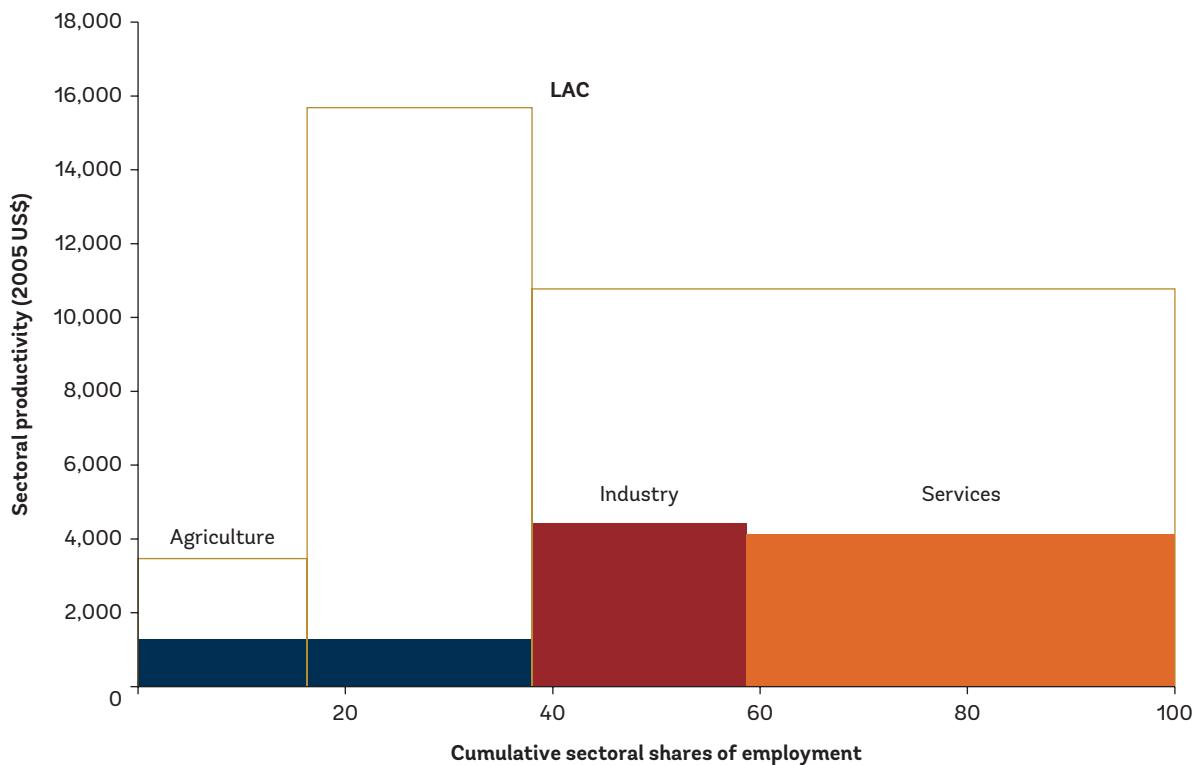
Source: World Bank 2015b.

Note: The category "other" is primarily made up of unpaid workers.

Creating the conditions for robust employment growth in high-productivity sectors is a pressing challenge, as demographic trends are causing a large number of new workers to enter the labor force. Roughly 60 percent of the Honduran population is under the age of 26, and a third is under the age of 14. Honduras' median age is the second lowest in the region and among the lowest 25 percent worldwide. Over the medium term the ratio of working age adults to dependent children and retirees is expected to increase substantially, creating the conditions for a "demographic dividend" in economic growth.

However, the extent to which Honduras is able to benefit from its changing demographics will depend on the ability of the private sector to create new jobs in high-productivity sectors. If the ongoing recovery generates a balanced

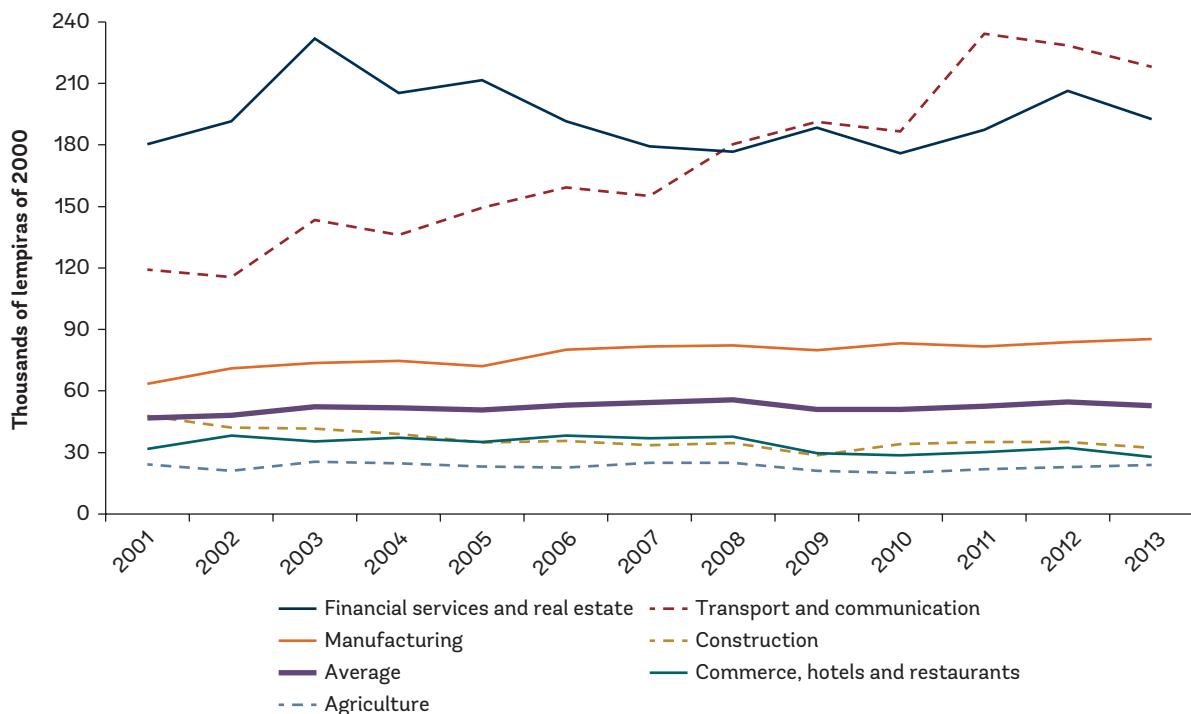
FIGURE 3.13 Compared with the LAC Average, Productivity in Honduras Is Low Across All Sectors
(Sectoral employment and productivity, 2011)



Source: World Bank (2015a).

Note: Colored boxes represent Honduras and outlined boxes represent LAC. Sector productivity is calculated as the ratio of sector's value added and the number of employees working in that sector. The shares of employment are the fraction of the workforce that works in that sector.

FIGURE 3.14 While Average Productivity Increased in the Transport and Communication Sector, Agricultural Productivity Stagnated
(Value added per worker by sector)



Source: Honduran authorities and World Bank estimates.

pattern of employment growth in manufacturing and high-value-added services similar to that observed in the pre-crisis period, the private sector will be able to leverage the demographic dividend to accelerate growth and poverty reduction. However, if employment growth slows or remains confined to agriculture and low-value-added industries, the influx of new workers could further depress wage rates, exacerbate poverty and contribute to a range of negative social outcomes. At present, educational indicators and youth employment opportunities in Honduras remain inadequate, as described in Chapter 4, underscoring the urgency of reforms in social services and the business climate.

While the Honduran labor market suffers from serious weaknesses, employment dynamics differ by sector. Before addressing the broader economy-wide challenges facing Honduras, including the constraints imposed by a rigid labor market, it is important to examine growth and job creation in specific industries. The

following section analyzes key industries in the agriculture, manufacturing and service sectors, each of which is either a major driver of employment and output, or a possible catalyst of income growth and poverty reduction. The potential impact of the further expansion of these industries is assessed, along with the constraints to their development.

3.3 Selected Industries and Their Growth Challenges

Agriculture, manufacturing and services each play an important role in the Honduran economy. In the agricultural sector the coffee and sugarcane industries remain a major source of employment and income for rural households, while palm oil production has recently emerged as a new force in the sector. The *maquila* light manufacturing model has led the growth of the industrial sector since its emergence in the 1990s,

yet it has struggled to recover in the wake of the global financial crisis. Before the crisis, transportation, communications and financial services drove the expansion of services, but in recent years tourism, including hotels and restaurant services, has become an increasingly important component of the sector.

Agriculture: Coffee, Palm Oil, and Sugarcane

Agriculture has long been the mainstay of the Honduran economy. Historically, agriculture has accounted for a larger share of output and employment in Honduras than in comparable LAC countries. The sector directly employs one-third of the Honduran labor force and accounts for about 30 percent of total exports. In 1970, agriculture represented 32.4 percent of GDP, double the LAC average of 16.6 percent for countries with available data. Today, agriculture represents 14 percent of Honduras' GDP, the second-largest share in LAC. And if agribusiness activities are included, the sector accounts for over 40 percent of GDP. Most small and medium producers grow low-value crops for consumption in the household and local markets and cultivated land is often on hilly terrain with poor access to water, roads, credit, modern production technology, improved seeds, tools, and basic inputs. Over the last two decades farmers and agricultural firms have gradually transitioned into higher-value products. Sector legislation promoted foreign and domestic investment in export commodities such as coffee, palm oil and sugar, which have also benefited from proximity and preferential access to large consumer markets, persistently low land and labor costs in rural areas, and the adoption of improved production processes. Agribusiness exports experienced robust growth over the past decade, rising from US\$600 million in 2006 to US\$3 billion in 2014. Agribusiness currently accounts for 63 percent of total exports. However, the agricultural sector remains highly vulnerable to both shifts in international prices and exogenous production shocks such as diseases and natural hazards.

Coffee. Coffee accounts for about a third of total agricultural production, represents about 5 percent of GDP, and directly employs 10 percent of the labor force. Two-thirds of coffee producers live below the poverty line, and half live in extreme poverty. About 90 percent of Honduran coffee is exported, and it is the country's second most valuable export after *maquila* manufactures. 92 percent of Honduras' 110,000 coffee growers are small farmers, who also account for the majority of coffee production. Output has increased in the last decade driven by productivity gains. Between 2001 and 2012, coffee production rose from 150 to 354 million kilograms, as farmers adopted new quality-control practices and introduced disease-resistant seeds, increasing marginal yields. Productivity gains have been especially strong in specialty coffee. However, access to finance remains an important challenge. While access to short-term credit for coffee farmers (e.g., pre-export credit) has improved, affordable long-term financing to support investments in infrastructure, technology, and enhanced inputs remains limited. This leaves the industry highly exposed to shocks. For example, the 2012–14 outbreak of rust-leaf disease ("roya") affected about 25 percent of Honduras' coffee crop, causing over US\$100 million in losses, much of which was borne by small farmers.

Palm Oil. Honduras is currently the ninth-largest crude palm oil producer in the world and the largest in Central America. Three-quarters of palm oil production (about 500,000 metric tons in 2015) is exported, and palm oil accounts for over 5 percent of total exports. Production has grown at an average rate of 10 percent per year since 2008. There are currently 12 oil-extraction plants operating in the country, and three more are expected to open in 2015–16, increasing total extraction capacity by 31 percent. In contrast to other Central American countries, palm oil production in Honduras involves a large share of independent smallholder producers. About 98 percent of palm oil production comes from approximately 18,000 small and

medium-sized farmers. These farmers are organized into producer groups, some of which operate their own extraction plants. Land tenure issues and environmental and social risks constrain the expansion of palm oil production. Uncertain property rights have led to conflicts over land, including armed confrontations and violence in the Bajo Aguan Valley. Producer organizations are committed to adopting best practices for environmental and social responsibility, but the capacity of most local producers remains weak. A public consultative process is currently underway in support of the prospective adoption of the International Responsible Palm Oil Criteria. Natural hazards are also a source of concern, as the majority of palm oil plantations are located in areas affected by hurricanes and floods. Finally, high energy costs are a major constraint on profitability, and producers have been forced to invest in biomass and biogas plants to generate their own electricity. The sector is also highly vulnerable to international prices, but Honduran palm oil producers have demonstrated resilience and a capacity to adapt to market dynamics.

Sugarcane. While its share of GDP has fallen over time, sugarcane remains one of the largest employers in the agriculture sector, directly generating over 16,000 jobs. About 40 percent of Honduran sugarcane is exported and the rest is consumed in the domestic market. Productivity gains have driven growth; between 2008 and 2014 yields improved by a full 39 percent, and production reached 11.3 million pounds of sugar per year. Enhanced refining processes and increased demand spurred by Free Trade Agreements with the United States, the European Union, and other countries further boosted output, though exports to the US remain constrained by regional quotas. A revised legal framework was approved by Congress in 2014 to regulate the production of biofuels derived from sugarcane and palm oil as additives for imported gasoline. This framework should expand opportunities for the sector over the long term. However, key challenges include ensuring adherence to environmental and health standards. Industrial accidents

in sugar production remain common, especially among sugarcane cutters. The burning of fields before the harvest is also a dangerous activity for workers, who often lack appropriate protective equipment, and causes environmental damage. Child labor is a major challenge. A 2013 human rights report by the US State Department claims that approximately 170,000 children between five and fourteen years old work as child laborers in Honduras, and many are engaged in harvesting sugarcane.

Manufacturing

The *maquila* industry has played a major role in Honduran manufacturing since the late 1990s and represents an important source of poverty reduction. The *maquila* model, in which imported components and intermediate inputs are assembled and re-exported, emerged following the trade liberalization reforms of the late 1990s. *Maquilas* currently comprise two-thirds of the manufacturing sector and 6 percent of GDP. Total *maquila* exports amount to about US\$3,900 million, of which around 80 percent are textiles, and over 70 percent of exports are bound for the US market. Over the past decade the industry has transitioned from a simple assembly-based production model to an increasingly sophisticated, vertically integrated industry, driving technological innovation and attracting a large amount of investment. *Maquilas* now account for the second-largest share of FDI after telecommunications. *Maquilas* employ three percent of the Honduran workforce (over 120,000 workers), 75 percent of whom produce textiles and garments, while another 12 percent produce automotive parts. Though it employs a relatively small share of the labor force, the emergence of the *maquila* industry has reduced poverty by an estimated 1.5 percentage points and expanded employment opportunities for women (De Hoyos, Bussolo, and Nunez 2008).

The growth of the *maquila* industry has slowed since the global financial crisis due to increasing international competition, particularly in textiles, combined with rising costs.

Honduran *maquilas* benefit from special tax regimes and employment incentives, but these are not sufficient to offset the erosion of competitiveness caused by high minimum wages and rising electricity costs. The industry is also constrained by a lack of new opportunities in the global market for manufactures. Since 2009 a number of *maquila* firms have relocated to other countries, including neighboring Nicaragua, where labor costs are lower.

Services, Commerce and Construction

Led by the transportation, communications and financial services, Honduras' service sector has been the main contributor to recent economic growth. Yet at 25 percent of GDP the sector remains far smaller than the regional average (50 percent). Despite the impact of remittances on consumption, the country's high poverty rates and small middle class limit the scope of the domestic market for services. By contrast, investment in the export-oriented *maquila* industry and agriculture sector has been relatively robust.

Communications. Growth in the communications industry has been boosted by large investment inflows, particularly FDI in the telecoms industry, which have financed technological upgrades and network expansion. Over the last decade, mobile services companies have increased the geographical coverage of their networks and diversified into cable and satellite television services, as well as data transmission. The 4G spectrum was allocated in 2013, improving the scale of internet access and data transmission. However, telecommunication quality indicators have not substantially improved over the past decade.

Financial Services. The financial services sub-sector has grown at a robust pace of around 5 percent per year over the last decade, and the industry currently generates about 21,000 jobs. Increasing loans to the commercial, agricultural and manufacturing sectors, combined with rising consumer credit, have driven the growth of financial services. Honduras' deposit and loan

rates are relatively high by regional standards. In 2013, the ratio of total deposits to GDP reached 48 percent, well above the average of 34 percent in Central America (excluding Panama), while the loans-to-GDP ratio reached 69 percent, compared to an average of 60 percent in Central America (excluding Panama). However, bankarization rates remain low (World Bank Global Findex 2015). Just over 20 percent of Honduran adults have an account at a formal financial institution, and only 5 percent have credit cards; both rates are far below the Latin American averages of 39 percent and 18 percent, respectively. The bankarization rate for individuals in the bottom 40 percent is just 13 percent and only 14 percent in rural areas. Despite the importance of remittances in the Honduran economy, only 4 percent of Hondurans report using formal financial accounts to receive remittances.⁴ And only 8 percent of Hondurans use bank accounts to receive wages (World Bank Global Findex 2015).

Tourism. Tourism is an emerging industry in Honduras. It is the country's fourth-largest source of foreign exchange and employs around 6 percent of the workforce. However, the sector has been waning in importance since the global financial crisis, and its share in total goods and services exports fell from 11 percent in 2009 to 7 percent in 2013. Tourism represents a smaller share of exports in Honduras than in neighboring countries such as Belize (31 percent), Costa Rica (14 percent) and Panama (12 percent). Honduras has the potential to compete with other top destinations in the western Caribbean, as it boasts impressive beaches and Mayan ruins, and in the last five years the number of international arrivals has increased rapidly. Improved infrastructure, notably the opening of a new airstrip in Copan and a new cruise ship port in Colon in 2014, has also helped the sector. There are currently about 2 million tourism arrivals per year, roughly half of which are cruise ship passengers. However, a number of important challenges constrain the sector's growth, including the high cost of both international and

domestic airfares, a growing reputation for crime and violence, and limited infrastructure development.⁵ The government is attempting to overcome these challenges through innovative sector development strategies such as establishing public-private partnerships to improve tourism infrastructure.⁶

Construction. The construction industry employs about 6 percent of the Honduran workforce and accounts for 3 percent of GDP, down by half since 2000. The sector was hit hard during the 2009 crisis. Due to weakening residential and commercial investment, the sector contracted by 8 percent per year during 2009–10, losing about 500,000 jobs. Construction output and employment both remain well below their pre-crisis levels. The share of total private investment allocated to residential construction is high in Honduras, indicating that the country's housing deficit presents opportunities for domestic investors. Yet the high cost of construction materials is a major constraint in the sector, as cement prices are rising faster than inflation. The Honduran cement industry is an imperfectly competitive duopoly, and the projected growth of demand over the next 3–5 years could create an opening for entry of new firms as existing producers reach maximum production capacity. Increased competition in the production of cement and other inputs could lower prices and accelerate construction activity.

While each of these industries faces specific constraints, a number of transversal challenges affect the competitiveness of the Honduran economy and deter job creation. Some of these issues have emerged recently, while others have inhibited Honduras' development for decades. Key cross-cutting issues include limited infrastructure, including energy and transportation; an underdeveloped financial sector; land tenure insecurity and limited administrative capacity for adjudicating and enforcing property rights; a burdensome regulatory environment that contributes to labor market rigidities and limited competition; and the rise of crime and violence, particularly organized criminal syndicates associated

with the international drug trade. The following section examines the impact of these factors on the Honduran economy and explores options for alleviating transversal constraints to growth.

3.4 Challenges to Competitiveness in Honduras

Over the past 15 years, two major issues have arisen as threats to Honduras' continued economic development: high levels of crime and emigration. These two forces have implications for growth and competitiveness as both imply an increase in business costs. On the one hand, Honduras has one of the highest rates of crime and violence in the world (see chapter 5.3). All three countries in the Northern Triangle—El Salvador, Guatemala and Honduras—have suffered from elevated crime and violence rates, as drug traffickers and gangs have grown more violent. These three countries top world rankings of homicide rates. On the other hand, the combination of violence and lack of opportunities has driven a large wave of out-migration from Honduras, largely to the US. These migrants have become a significant source of income, with remittances accounting for 17 percent of GDP. As in neighboring El Salvador, this has led to symptoms of Dutch disease in the economy. Combined with the country's relatively high minimum wages, this has led to increased labor costs.

Security Costs: The Economic Impact of Crime and Violence

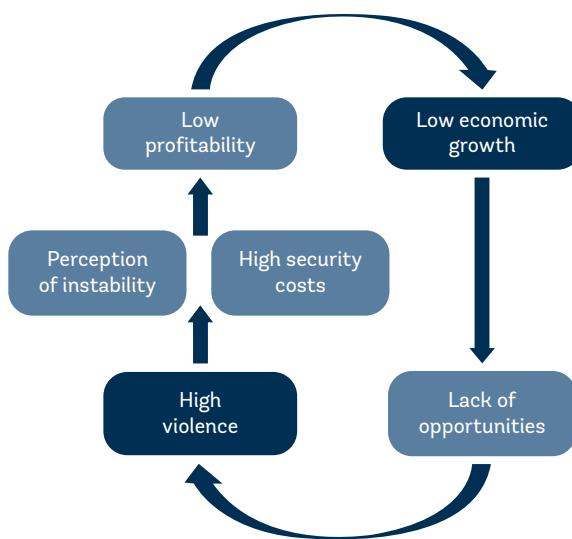
Crime, violence, and insecurity distort incentives to invest in human capital, impose direct and indirect costs on firms, lower household welfare directly through lost wages and labor, and divert government resources from public investment and poverty alleviation to law enforcement and criminal justice. The economic cost of crime in Honduras is staggering, reaching an estimated 10 percent of GDP (US\$ 900 million) in 2011. Insecurity substantially increases the cost of doing business in virtually all sectors, and private

firms spend an average of about 9 percent of their annual profits on security costs (World Bank 2011a). Crime impacts firms in a number of ways, and extortion, kidnapping and other forms of racketeering are becoming increasingly common.

Crime and violence increase operational costs, erode competitiveness and discourage private investment. In some cases, such as the *maquila* sector, international firms may shift investment to more secure destinations. And while sectors such as extractive industries and fixed-crop agriculture are more likely to remain in operation despite high crime rates, insecurity costs will inevitably diminish profit margins. There is mounting evidence that fear of crime, particularly extortion, has prompted some businesses to exit the marketplace altogether. For instance, the World Bank's Enterprise Surveys identify crime and violence as one of the most important problems facing Honduras.

Low economic growth and criminal violence have become locked in a vicious cycle (figure 3.15). Low growth limits income and employment opportunities, creating incentives to profit from crime, and widespread poverty reduces the ability of the population to resist crime and demand action from public agencies. These incentives and vulnerabilities become increasingly acute in

FIGURE 3.15 The Cycle between Low Growth and Violence



countries where criminal enterprises have developed a strong organizational infrastructure and enjoy high rates of impunity. As crime and violence damage economic competitiveness, discourage investment and drive firms from the market, they improve the conditions for their own survival and proliferation. The rise of crime and violence also contributes to increased migration, spurring a second vicious cycle that further constrains economic growth.

KNOWLEDGE GAP What Is the Full Cost of Crime to the Honduran Economy?

Media reports suggest that gang violence and extortion have resulted in the closure of small businesses, causing employment losses. While some gangs profit from the international drug trade, others generate income primarily through extortion payments from businesses and citizens, commonly known as the "*impuesto de guerra*," or "war tax"^a. Extortion demands range from US\$20 to US\$5,000 per month, and failure to pay often results in harassment, death threats, or violence by gang members. In 2012, the *impuesto de guerra* was estimated to have caused the closure of approximately 1,600 businesses in Tegucigalpa alone. Together these firms employed nearly ten thousand workers and consisted primarily of bakeries, beauty salons, food stands, hardware stores and other small and medium enterprises (*El Heraldo* 2014). Extortion payments have also affected activity in the capital's central market, *Mercado Las Américas*, where by 2015 an estimated 500 food and clothing vendors had been reduced to just 50 (*La Prensa* 2015).

a. United Nations Office on Drugs and Crime.

Migration, Remittances and Labor Costs

Since the late 1990s the emigration of Honduran workers has dramatically increased, spurred by low growth rates and accelerated by rising levels of crime and violence. Migration and remittances play a complex role in the Honduran economy, one that generates both positive and negative outcomes. Migration can offer productive workers a means to escape from limited labor market opportunities, and remittance inflows have had a demonstrably positive impact on poverty rates. Honduras receives the largest remittance inflows in Central America as a share of GDP (over 17 percent in 2014), and remittance levels have increased over the past decade. According to the Central Bank of Honduras' biannual remittances survey, the average monthly remittance reported by recipients is US\$477, or almost 2.5 times Honduras' monthly per capita income. Yet, by drawing off a significant share of the labor force, migration adversely impacts aggregate productivity. Moreover, the process of migration itself requires capital to achieve. As a result migrants rarely come from among the poorest households in Honduras, and remittance income rarely reaches them.

Low growth rates and high migration rates can be mutually reinforcing. Remittances have been found to contribute to "Dutch disease" effects, as high capital inflows result in real exchange-rate appreciation (Acosta, Fajnzylber, and Lopez 2008). A rise in household income through the inflow of remittances leads to an increase in consumer demand, which raises prices for domestic nontradables, prompting a reallocation of labor away from the tradable goods and a real exchange rate appreciation. Among LAC economies, a one percentage point increase in remittances as a proportion of GDP is estimated to lead to a real-exchange rate appreciation of 2.5 percent if remittances are taken as exogenous to 18–24 percent if the models correct for reverse causality in which real exchange rates also affect remittances.⁷ Rising domestic demand and the decreased competitiveness of domestic

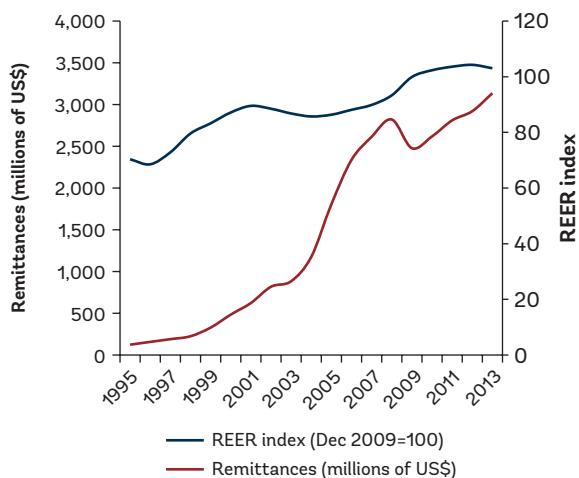
producers of tradable goods also widens the current-account deficit, weakening the country's macroeconomic position. Migration also has direct implications for growth by reducing the size of the labor force as workers self-select out of the country, potentially generating brain drain and slowing the accumulation of skills in the economy. And, as household income rises, reservation wages increase and the labor supply falls.

There is evidence of a vicious cycle between migration and low growth in Honduras. Low growth and a resulting lack of opportunities, further exacerbated by the country's high violence, drive migrants to seek work outside of Honduras. These migrants, in turn, send home millions of dollars in remittances. Evidence of Dutch disease as a result of the country's high remittances can be seen in the relationship between real exchange rate and remittances (figure 3.16). Between 1995 and 2013, there has been a strong correlation between growth in remittances and in the real exchange rate. At the same time, there is evidence of lower labor supply among recipients of remittances—both in the literature and from chapter 2 (Acosta et al. 2008). This implies a higher reservation wage and thus upward pressure on wages. Through a higher real exchange rate and higher wages Honduras loses competitiveness in world markets, limiting, in turn, opportunities for further economic growth. This loss of competitiveness, and its negative effect on the business climate, closes the negative cycle of migration on economic growth (figure 3.17).

3.5 Chronic Constraints to Economic Growth

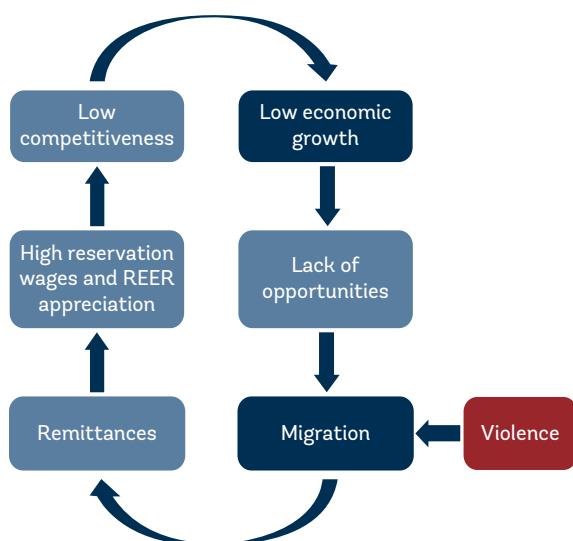
While high crime and violence combined with high migration pose serious challenges to growth, the reality is that Honduran growth challenges predate these two cycles. Earlier comprehensive studies, cross country regressions, and micro economic data reveal that some challenges have been chronic or persistent in hindering growth since the 1960s (table 3.1). Well-documented evidence on competitiveness and growth challenges in

FIGURE 3.16 The Real Effective Exchange Rate Has Appreciated as Remittances Have Risen (REER index and remittances inflows)



Source: Honduran authorities and World Bank estimates.

FIGURE 3.17 The Cycle between Low Growth and Migration



Source: Honduran authorities and World Bank estimates.

Honduras identifies five long-term challenges that harm firm productivity, job creation, and make investment in Honduras more expensive:

- *First*, persistent fiscal instability and macroeconomic imbalances were mentioned as a major challenge in the 1987 CEM, were the main focus of the 1994 CEM report, and were

highlighted as a major issue in cross-country regressions.

- *Second*, low endowment of human capital and a limited supply of skilled labor were mentioned in all the comprehensive reports reviewed and has been identified as an important growth deterrent. Low educational attainment is also significant in cross-country regressions and the lack of a skilled workforce is among the major constraints reported by firms in the World Bank's Enterprise Surveys.
- *Third*, inadequate infrastructure was cited in the 1999 IMF report on Honduras' growth as an issue since the 1970s, also appearing in the 2004 Development Policy Review (DPR) report as one of the four major challenges to competitiveness and growth, and also highlighted by the cross-country regressions.
- *Fourth*, limited access to capital was mentioned as one of the four major constraints to growth in the 2004 DPR report, was among the top five concerns for firms in the Enterprise Surveys, and is statistically significant in the cross-country regressions.
- *Fifth*, weak governance, with particular attention to a poor regulatory environment, was highlighted in the 1987 CEM report which mentioned the complex legal and institutional regulatory framework. The 1999 IMF report also mentions an inadequate institutional infrastructure, while the cross-country regressions also highlight this challenge.

Fiscal and Macroeconomic Instability

High levels of debt have repeatedly destabilized the public finances, undermining investor confidence and wealth creation, slowing growth, and limiting the authorities' ability to cope with both unexpected disasters and cyclical downturns.⁸ This vulnerability is illustrated by Honduras' experience following the global financial crisis, when an unsustainable fiscal stance left the government ill prepared to combat the effects of a deteriorating external environment combined with an internal political crisis which led to the temporary suspension of aid from most of the international

TABLE 3.1 Chronic Challenges to Competitiveness in Honduras
(Summary of findings from previous studies)

Key constraints identified						
1. Comprehensive growth reports						
1987 CEM	Fiscal & macro instability	Regulatory framework	Low human capital			
1994 CEM	Fiscal & macro instability		Low human capital			
1999 IMF		Institutional infrastructure	Low human capital	Low infrastructure		
2004 DPR		Weak governance	Low human capital	Low infrastructure	Limited access to finance	
2. Cross-country benchmarking						
Loayza et al. (2005)	Cyclical volatility		Education	Infrastructure	Financial depth	
Araujo et al. (2014)	Macro instability	Government burden	Education	Infrastructure	Access to credit	
3. Microeconomic evidence						
2010 Enterprise Survey	Political instability		Inadequate workforce		Access to finance	Corruption
Microeconometric analysis		Regulatory compliance				Crime
CHRONIC CHALLENGES TO COMPETITIVENESS AND GROWTH IN HONDURAS						
	Fiscal & macro instability	Weak governance	Low human capital	Low infrastructure	Limited access to finance	

Note: Comprehensive studies on Honduras' growth include the 1987 and 1994 World Bank's Country Economic Memorandums (CEM), a 1999 growth report by the IMF, and the 2004 World Bank's Development Policy Review (DPR). These studies are complemented by evidence from cross-country regressions on the constraints to growth, including Loayza et al. 2005 and Araujo et al. 2014, as well as microeconomic data.

community. While any economy would suffer facing those conditions, the effect in Honduras was particularly negative resulting in a multi-year period of losses in social gains—poverty rates and income inequality increased between 2010 and 2012, erasing the gains made since 2003. Fiscal consolidation efforts and an improvement in external conditions resulted in a partial recovery in economic growth after the crisis, but growth slowed again in 2012–13 in a context of worsening terms of trade (figure 3.18).

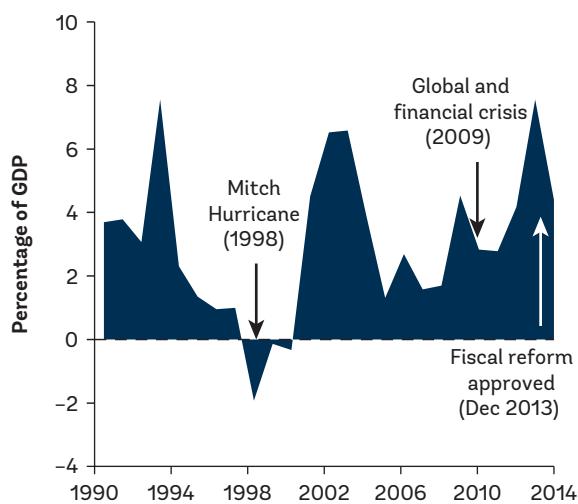
Despite support by the Multilateral Debt Relief initiative for Heavily Indebted Poor Countries (HIPC), which cut the public external debt stock by half in 2005–07, in 2014 the Government was spending a higher share of its revenues to service debt payments than it had in 2004 before the debt relief (figure 3.19). The accumulation of debt implies that the government must spend a significant amount of its revenues in servicing its debt, leaving little room for countercyclical policies. Notably, both domestic and external debt levels

increased following the global financial crisis, with external debt rising by 26.3 percent in 2013 alone following the government's issuance of US\$ 1 billion in international sovereign bonds. Moreover, financing costs have increased from 0.7 percent of GDP in 2009 to close to 3 percent of GDP in 2015, and the stock of public debt has almost reached 50 percent of GDP.

Rising fiscal deficits have contributed to the deterioration of Honduras' external position (figure 3.20). Government expenditures have played a crucial role in the dynamics of the current account deficit; every extra US\$100 spent by Honduras' government is associated with an increase in the current account deficit of US\$14, keeping everything else constant (Varela et al. 2015). Honduras has consistently run current account deficits for the past 20 years. From 2009 to 2011, the widening in the current account deficit can largely be attributed to a recovery of national investment in the aftermath of the global financial crisis—up from around 20 percent of GDP in 2009

FIGURE 3.18 Sustained Fiscal Deficits Have Been Punctuated by Sporadic Attempts at Fiscal Consolidation

(Timeline of the fiscal deficit, 12-month moving average)



Source: Honduran authorities and World Bank estimates.

to 26 percent in 2011, which was not matched by a commensurate rise in domestic savings. However, the continued widening in the current account deficit since 2011, from 2.8 percent of GDP to 7.6 percent in 2013, has coincided with declines in national investment and by even greater declines in national savings.

Low Endowment of Human Capital

Honduras' low endowment of human capital creates a competitiveness gap with peer countries, making it difficult for Honduras to compete internationally and may partially explain its labor productivity deficit. While education and access to other basic services are discussed in greater detail in chapter 4, it is important to stress that despite relatively high levels of public spending on education, Honduras faces challenges in coverage, equity and quality. Despite the universalization of primary

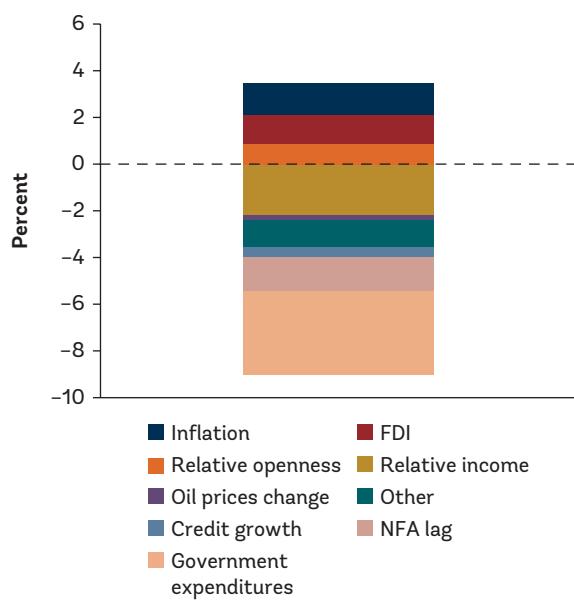
FIGURE 3.19 The Government Spends a Significant Amount of Its Revenues in Servicing Debt

(Debt-to-GDP ratio and debt service as a share of revenues)



Source: Honduran authorities and World Bank estimates.

FIGURE 3.20 The Fiscal Deficit Is a Key Determinant of the Current-Account Deficit
(Determinants of the current account deficit in Honduras, 1992–2012)



Source: Varela et al. 2015.

Note: NFA is Net Foreign Assets.

education, access at all other levels of education continues to be strikingly low. High dropout rates in Honduras exist despite high returns to education, reflecting low educational access and quality (figure 3.21).⁹ The tertiary enrollment rate is just 20 percent, compared to 45 percent in large LAC countries and 25 percent in neighboring Central American countries. Low quality of schooling further compounds this effect: only one third of the students who finish secondary education are able to achieve satisfactory scores in tests to enter higher education (box 3.2) (ILO 2013). Poor schooling outcomes also impacts the crime and migration cycles detailed above; for example, high dropout rates increase the *nini* population—youth who are neither working nor in school, an especially vulnerable group for joining criminal activities.¹⁰ Finally, lack of proper nutrition and access to basic health and water and sanitation also have negative implications for learning abilities, labor capacity, and earnings potential.

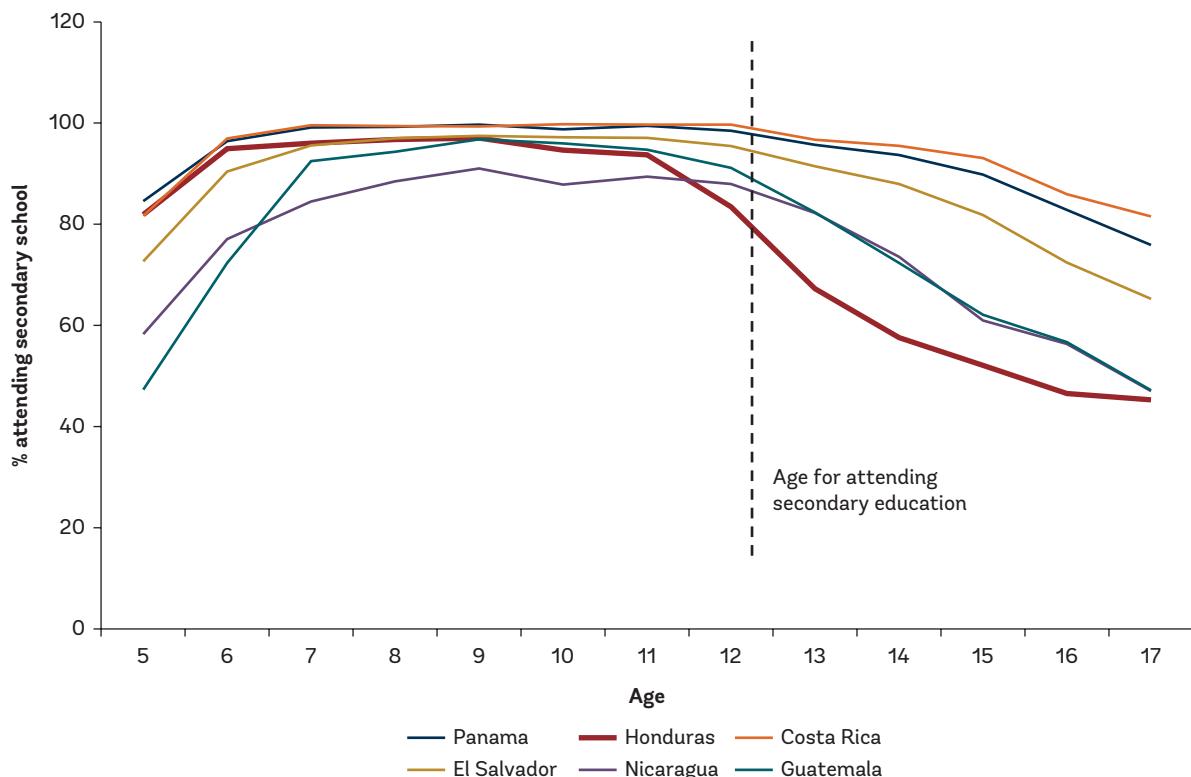
Low levels of schooling imply a limited supply of adequately trained labor, which has resulted in a mismatch between the supply of skills and the

demand for workers. The average Honduran over the age of 15 has only 6.2 years of schooling, lower than the Latin America average of 8.4 years, and this gap has widened since 1990.¹¹ While other countries in the region have seen larger increases in educational attainment over the last 20 years, the educational attainment of the labor force in Honduras has increased by only 1.3 years of schooling (figure 3.22). This has resulted in an increasing human capital gap between Honduras and Latin America, in terms of years of education: in 1990, it was of 1.7 years but by 2010 it had increased to 2.2 years. A lack of skilled labor is among the top five business environment constraints identified by business owners and more than one in ten firms (11.4 percent) identified an inadequately educated workforce as the biggest obstacle for their business (World Bank Enterprise Survey 2010). Moreover, this could be an underestimate as many firms in Honduras may not be more skill-intensive as a consequence of the low levels of human capital in the country. In other words, the scarcity of talented labor prevents highly-productive industries from emerging (ILO 2013). To address the scarcity of skills, a third of private companies offer in-house training for their employees (World Bank Enterprise Survey 2010). Training for technical careers can help reduce the lack of skills in the economy and, in fact, in 2011 around 190,000 workers (5.8 percent of the labor force) were certified by technical institutions. However, it is worth mentioning that of these workers, less than 90,000 were fully employed (ILO 2013), though this was during a period in which overall employment creation slowed down.

Inadequate Infrastructure, Especially in Transport and Energy

Weaknesses in core infrastructure, especially transportation and energy, and logistics compromise the international competitiveness of Honduran firms, reducing gains from trade and increasing prices for traded goods. On the two most widely used international rankings of transport service provision—the World Economic

FIGURE 3.21 Honduras' Labor Force Is Less Educated than Those of Similar Countries; Access to Post-Elementary Education Is Low
(School attendance rates by age, 2013)



Source: World Bank 2015b.

Forum's Global Competitiveness Index and the Logistics performance Index—Honduras ranks slightly below the median among the 140–160 countries ranked, scoring below neighboring Central American countries. Honduras' poor performance in logistics is across both infrastructure gaps and service quality (figure 3.23). Despite efforts to increase infrastructure coverage, Honduras still lags neighboring countries. Road density in Honduras is only 15 percent of Costa Rica's road density, and it lags behind Nicaragua, Panama and El Salvador. Moreover, Honduras has one of the lowest rural electrification rates in the LAC region, with a quarter of the rural population lacking access to electricity.

In the case of transport infrastructure, key challenges include low access and deficient quality. Inefficiencies in the road transportation network affect both international trade and domestic commerce. A large share of internationally traded

goods utilize multiple transport modes, usually road and sea or road and air. Rail service is limited to a few dedicated short-distance routes used for transporting lumber or agricultural products to nearby ports, while the overwhelming majority of overland freight is transported by road. Despite its importance, the road network has been deteriorating as a consequence of limited public resources and setbacks in the capacity of the agencies responsible for road pavement. As a result, more than 50 percent of roads in Honduras are in a poor condition.

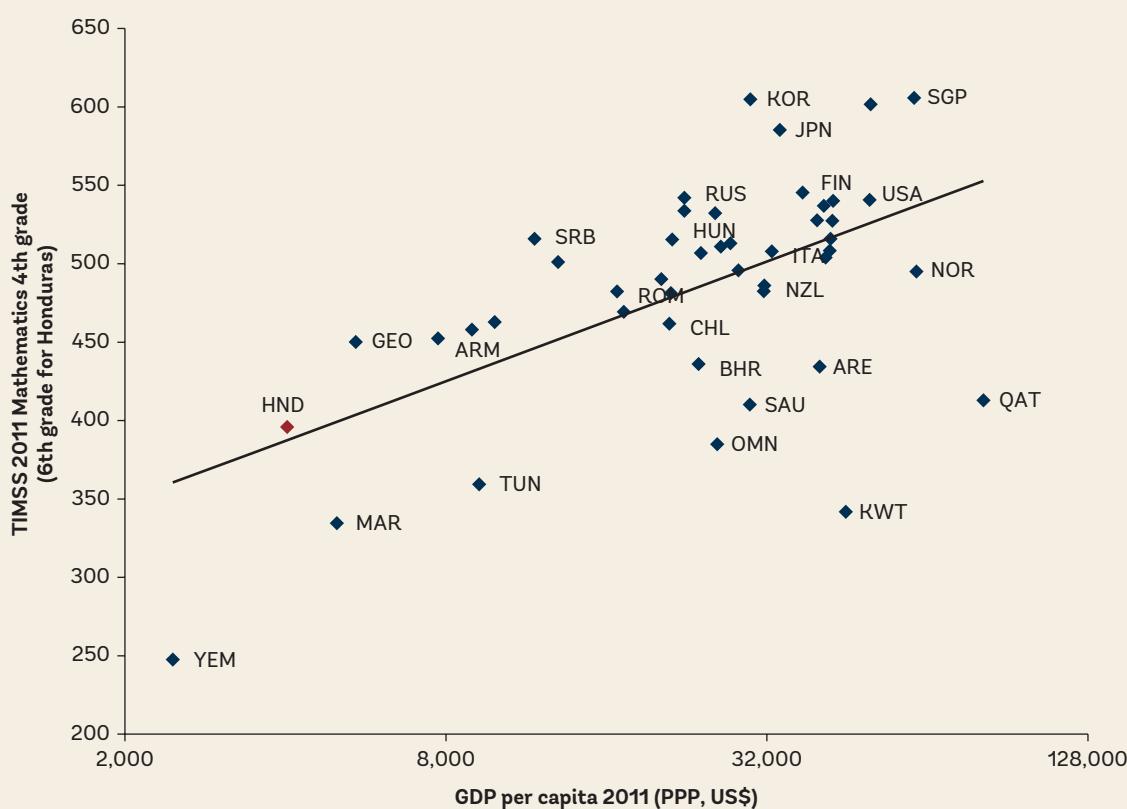
High rates of crime and violence and logistical weaknesses, including empty backhauls, long wait times, and corruption issues, all increase road transport costs. Over the past three years average security costs related to transportation have increased by close to 20 percent, and they now represent about 5 percent of total trucking costs. Long loading times and delays at weigh

BOX 3.2 Quality of Schooling

Quality of schooling in Honduras remains internationally low, with Honduran students underperforming in language, mathematics and science. International assessments in 2011, the Trends in Mathematics and Science Study (TIMSS) and Progress in International Reading and Literacy Survey (PIRLS), confirm that Honduran students are performing below average. Even though 4th grade tests were applied to 6th graders in Honduras, by recommendation of the TIMSS and PIRLS International Study Center, Honduran 6th graders underperformed in TIMSS Mathematics (figure B3.2.1) and PIRLS. Similarly, despite the 8th grade test being applied to 9th graders, results in TIMSS Mathematics were even lower.

FIGURE B3.2.1 Honduran Students Are Performing below Average in Mathematics

TIMSS 2011 Mathematics 4th grade in relation to GDP per capita (6th grade for Honduras)



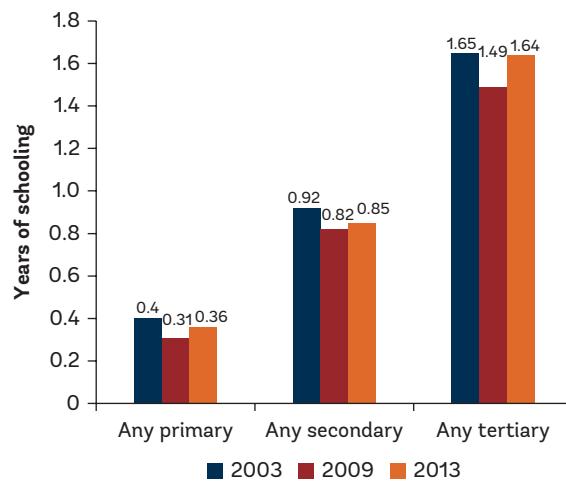
Source: World Bank 2015b using TIMSS 2011 Assessment.^a EdStats.

a. Copyright © 2012 International Association for the Evaluation of Educational Achievement (IEA). Publisher: TIMSS & PIRLS International Study Center, Lynch School of Education, Boston College, Chestnut hill, MA and International Association for the Evaluation of Educational Achievement (IEA), IEA Secretariat, Amsterdam, the Netherlands.

stations represent around 20 percent of total shipping time along the country's main routes. Administrative costs are especially high for international freight, as wait times at customs and inspection stations can represent as much as 15–20 percent of the total shipping time on

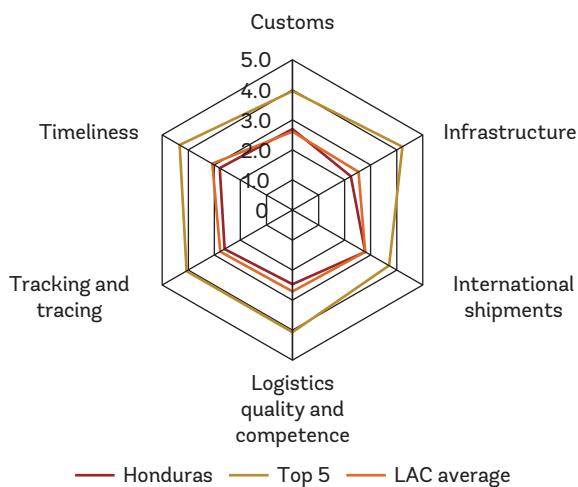
international routes. Moreover, a large share of overland shipments return with empty back-hauls, which pushes up prices in order to cover the cost of the empty return trip. Trucking companies report high informal payments to the police along both national and international

FIGURE 3.22 Returns to Education Are High
(Returns to education in Honduras, 2003–13)



Source: World Bank 2015b.

FIGURE 3.23 The Poor Performance of the Logistics Sector Is Due Not Only to Infrastructure Gaps, but Also to Lack in Service Quality
(Logistics performance index; 5=best)



Source: WBG Logistics Performance Index 2014.

Note: Top 5 countries for Logistics Performance Index include: Germany, the Netherlands, Belgium, the United Kingdom, and Singapore. LAC countries include: Chile, Panama, Argentina, El Salvador, Brazil, the Bahamas, the Dominican Republic, Jamaica, Peru, República Bolivariana de Venezuela, Guatemala, Paraguay, Ecuador, Costa Rica, Uruguay, Nicaragua, Colombia, Honduras, Bolivia, Guyana, Haiti and Cuba.

overland routes, as well as border clearance payments to both official and unofficial customs agents (Osborne et al. 2014).

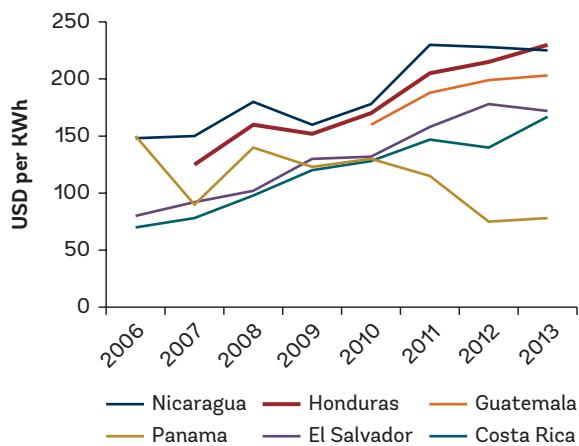
Given the importance of agriculture to the Honduran economy, particularly to households

living in poverty, connecting rural areas to urban markets is one of the country's main transport and logistics challenges. Good transportation infrastructure is especially important for agricultural trade, in order to open access to international markets for small farmers. Road infrastructure efforts could connect the large agricultural population to global markets, contributing to poverty reduction by increasing the rural poor's opportunities. Additionally, due to the perishable nature of most agricultural products, there is a particularly high premium on improved and speedy transportation options.

High energy costs undermine competitiveness and productivity by increasing production costs. At approximately 25 percent above the LAC average, the industrial price of electricity in Honduras is one of the highest in the region (figure 3.25). High electricity cost and unreliable service erode competitiveness, especially in those sectors with higher energy intensity, and divert investments to neighboring countries with lower industrial electricity prices. In 2013, Honduras' industrial tariffs were the highest in Central America, surpassing Nicaragua's rates (figure 3.24). Moreover, 7.6 percent of the electricity comes from back-up generators, a higher share than in Latin America (4.8 percent) (World Bank Enterprise Survey 2010). To counteract the unreliable and expensive electricity service in Honduras, the *maquila* industry in the country produces its own electricity from biomass. This implies a significant sunk cost, which may discourage new entrants.

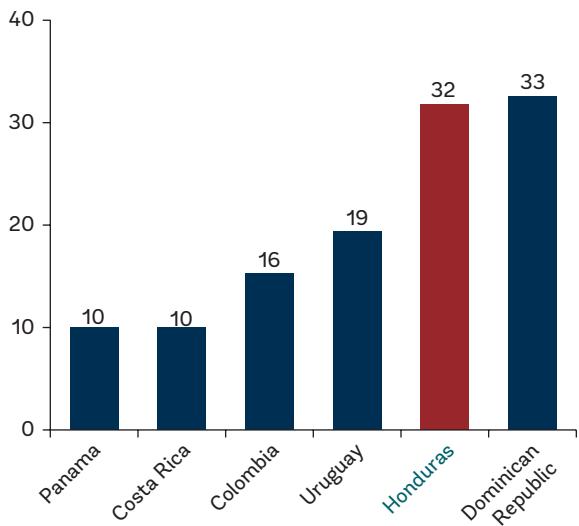
The high share of obsolete, inefficient and expensive thermal generation in the energy matrix and price tensions in an under-supplied market are the main structural reasons for high electricity prices. First, Honduras' energy mix relies heavily on thermal generation (55 percent), surpassed in Central America only by Nicaragua (59 percent). The cost of thermal generation is not only influenced by oil prices but also by expensive thermal generation power purchase agreements. Second, power demand exceeds supply by around 100 MW. This gap is driven by

FIGURE 3.24 Industrial Tariffs of Electricity Are the Highest in Central America
(Average electricity price for the industrial sector)



Source: Bloomberg New Energy Finance.

FIGURE 3.25 High System Losses Undermine the Efficiency of the Electricity Sector
(System losses, percent, circa 2013)



Source: World Bank staff calculations based on information from Grupo ICE (Costa Rica), UTE (Uruguay), CDEEE (the Dominican Republic), EDEMET (Panama), ENEE (Honduras) and Colombia (EPM Energy Colombia). Data for Colombia are for 2011.

limited generating capacity, but demand is also artificially inflated through distorted price signals produced by electricity subsidies, theft and fraud. Insufficient supply prompted Honduras to increase its electricity imports, which rose from 3.5 percent of GDP in 2010 to 4.9 percent

in 2014. To fill this supply gap, the Government is promoting different efforts: 1) bolstering supply in the short run through costly agreements with private energy generating firms, particularly during the summer time when water reservoirs are at low levels, affecting hydroelectricity production; 2) reducing future production costs through a recently signed agreement with Guatemala to import gas via the planned Mexico-Guatemala gas pipeline;¹² and 3) pushing for further expansion of renewable energy.

Inefficient transmission and distribution systems exacerbate the impact of expensive and limited generation capacity on electricity prices (box 3.3). ENEE, the state-owned electricity company is in charge of electricity transmission and distribution, while private companies generate two-thirds of the electricity produced. It lacks an adequate cost recovery scheme: the tariff adjustment mechanism is inefficient, there are substantial non-commercial losses, and there are deficiencies in the billing and collecting systems (figure 3.26). Together, these contribute to large company losses—in 2013, for example, ENEE registered a deficit equivalent to 1.8 percent of GDP. Recent reforms have improved the targeting of subsidies, but until recently, the residential sector was significantly cross subsidized by the industrial and commercial sectors. After the recent subsidy reform in 2014, estimates show that the cost recovery ratio in the residential sector has increased to 95 percent, from 65 percent. The tariff adjustment mechanism was also modified in 2014, resulting in a tariff increase estimated at 15 percent. Even so, total losses amount to about 30 percent. ENEE's losses are borne by the government and thus reduce fiscal space for public initiatives and investments in other sectors.

In a context of limited fiscal space, the government has begun promoting private sector investment in public infrastructure. In 2010, it created COALIANZA, a commission tasked with promoting public-private partnerships for public works. COALIANZA is still a relatively new institution, and strengthening its capacity

BOX 3.3 Governance Challenges in ENEE

ENEE is one of the few remaining vertically integrated power utilities in Latin America and faces governance challenges. In Honduras, only the generation business has been opened to private investors. ENEE is solely responsible for the transmission and distribution businesses, which are aggregated in regional clusters with a high level of decision autonomy in expenditures. In contrast, ENEE's decisions on power purchases to meet the demand are centralized, and billing and collection are outsourced to the private sector, with suboptimal control from ENEE. As a result of this decentralized/centralized structure, the regional clusters hold limited accountability for financial results and hinder corporate control on losses and expenditures, impacting negatively on ENEE's performance. At the same time, ten CEOs have led ENEE since 2005; this has resulted in weak governance, lack of a long-term strategy, limited internal control and has deteriorated the company's operational and financial performance.

Obsolete internal control systems lessen the management capability to run the company efficiently. Information provided by the internal control systems to the decision-makers is usually inadequate, unreliable and frequently not available in a timely manner. A symptom of this deficiency is the unsuccessful attempt of ENEE to go through an audit process of its financial statements in the past. The lack of reliable information and acceptable internal control procedures have been central arguments raised by the Auditing Companies for not subscribing ENEE's financial statements. Last auditing took place in 2010 with negative results. Based on the comments of the auditing company and supported by multilateral organizations, including the World Bank, ENEE has undertaken the auditing of its 2014 financial statements. This exercise is expected to be concluded by 2016.

The World Bank Group is collaborating with the Government of Honduras to improve ENEE's institutional framework. The Bank has supported the implementation of adequate internal control systems and the definition of a modern organizational structure, in line with best international practices. These instruments altogether with ENEE's further modernization, legislative reforms in the power sector—General Law of Electric Industry approved in 2013—and strong political willingness and support, will be key to overcome the current situation and improve the governance of the institution. The Government of Honduras has given first steps towards a structural change in the sector, by appointing the three Commissioners of the recently created Regulatory body (*Comisión Reguladora de Energía Eléctrica*, CREE) on June 19, 2015 and by approving ENEE's new organization structure.

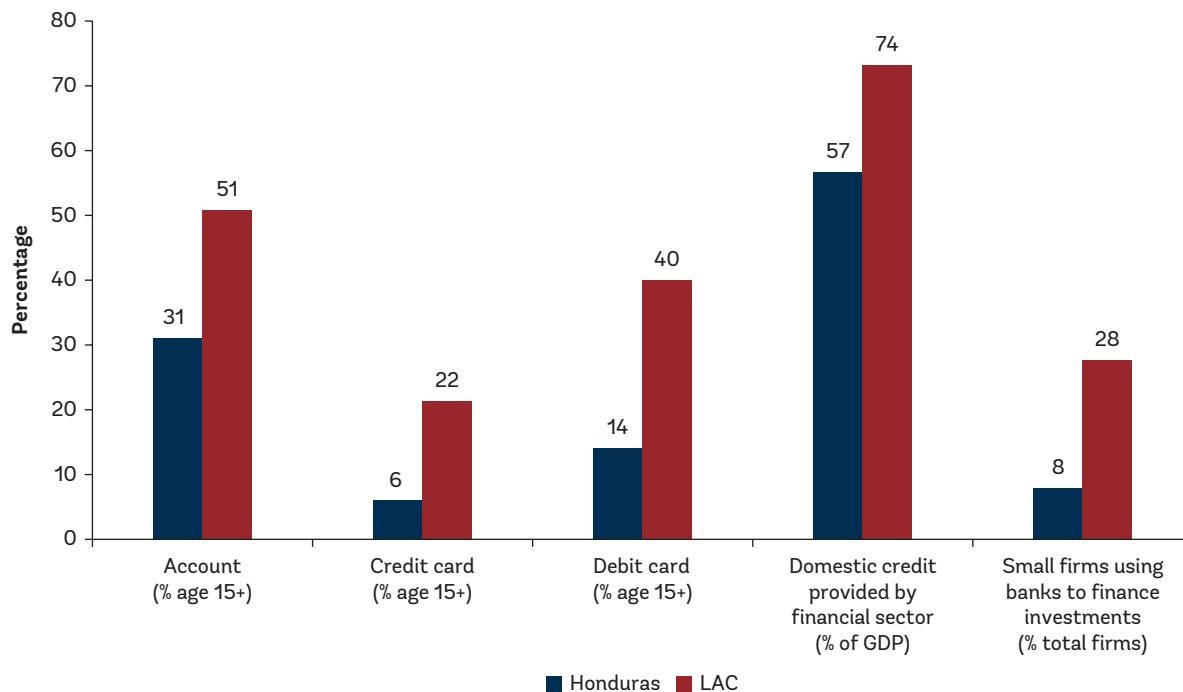
and that of its regulatory body will help to ensure that purchasing power parity (PPPs) are structured around principles of competitiveness and good governance. The existing legal and operational framework for PPPs allows for private sector investment in certain large infrastructure projects. PPP contracts have been tendered, both by COALIAZA and by private banks serving as trust agents, for projects involving the development of maritime ports, toll roads and urban road infrastructure.

Limited Access to Capital

While access to finance in Honduras has improved in the last decade, access to credit remains a challenge, and high interest rates undermine

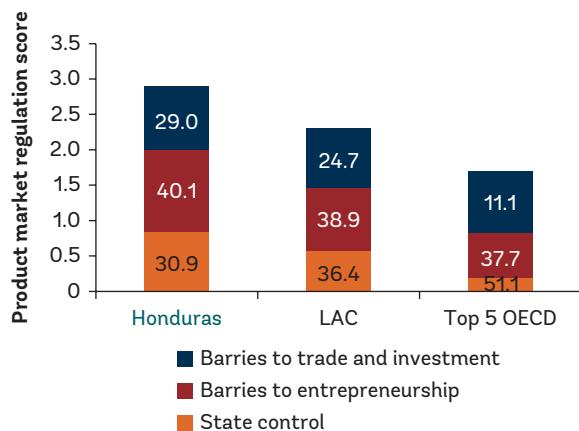
firm-level competitiveness (figure 3.27). About 81 percent of Honduran firms have a checking or savings account, more than 10 percentage points below the LAC average. Moreover, only 31 percent of these firms have a line of credit, well below the LAC average of 46 percent. About 15 percent of firms identified access to finance as a major constraint to doing business, the third most-cited constraint after political instability and corruption (World Bank Enterprise Survey 2010). Small firms were 20 percent more likely than medium-sized firms and 94 percent more likely than large firms to identify access to finance as a major constraint on their operations.¹³ While short-term working capital can be secured with guarantees on future production, long-term financing for

FIGURE 3.26 Access to Credit in Honduras Is Low in Comparison with LAC
(Selected financial indicators)



Source: Honduran authorities, FINDEX, and World Bank estimates.

FIGURE 3.27 Honduras' Regulatory Environment Appears to Be More Restrictive to Competition than the Regional Average
(OECD Product Market Regulation Indicator, circa 2014)



Source: World Bank Group/OECD PMR data 2013–14; World Economic Forum Global Competitiveness Report 2014–15; and World Bank estimates.

Note: Higher values are associated with regulations more restrictive to competition. Non-OECD LAC countries include: Argentina, Colombia, Honduras, Peru, El Salvador, Costa Rica, the Dominican Republic, Nicaragua, Jamaica and Brazil. Top 5 OECD countries include: the Netherlands, the United Kingdom, Austria, Denmark and New Zealand.

investment in infrastructure and technology is limited. Consequently, only 17 percent of firms in Honduras reported having investments financed by a bank, compared to an average of 33 percent in LAC. The proportion of loans requiring collateral (81 percent), and the average value of the collateral required (222.4 percent of the loan), are both relatively high. In LAC, 72 percent of loans require collateral, and its average value is 204 percent of the loan (World Bank Enterprise Survey 2010). High interest rates further hinder opportunities to access financing, and real lending rates in Honduras are higher than in many LAC countries, as well as other countries with similar income levels. Interest rate spreads (the lending rate minus the borrowing rate) in Honduras are among the highest in Central America, behind only Costa Rica, and above the average for Latin America. While investment rates are relatively high in Honduras, high interest rates and collateral requirements suggest that investment could be expanded.

Financial inclusion remains low and credit concentrated. Banks are profitable, liquid, well-capitalized and domestically funded, and their recent performance on key financial-soundness indicators has been robust.¹⁴ Private sector credit to GDP is 54.1 percent and domestic bank deposits represent 47.5 percent, both above the regional averages (41.0 and 41.3, respectively) and above the expected medians compared to its level of development (32.5 and 44.3, respectively).¹⁵ While Honduras' banking system is sound, financial inclusion indicators are among the lowest in the region, with the percentage of adults with access to a bank account reaching only 32 percent, while LAC averages 51 percent. Moreover, credit is highly concentrated; 90 percent of all outstanding banking loans are concentrated in three provinces: Francisco Morazán, Atlántida and Cortes. In addition, the recent expansion of credit was concentrated in consumption and housing, rather than productive activities. Driven by the increased use of credit cards, consumer credit as a share of total new credit rose from 25 percent in 2007 to 50 percent in 2012 (ILO 2013).

Despite the importance of agriculture in the economy, rural sector lending remains limited and agricultural loans represent only 5 percent of total outstanding loans. The appetite for rural-based lending has diminished, and private banks view rural borrowers as very risky. This is driven by high default rates after disasters associated with natural events, compounded by the government's loan forgiveness program for the sector.

Issues surrounding property rights are another challenge to access to capital in Honduras. Approximately 80 percent of privately held land in rural areas and 30 percent in urban areas is untitled or improperly titled.¹⁶ As a consequence of this uncertainty in property rights, informal land markets are active in urban and rural areas.¹⁷ Moreover, mortgages and other forms of credit are difficult to obtain due to the unclear nature of land tenure. An adequate provision of property rights increases incentives to invest (particularly long-term investment) and prevents distortions in investment decisions. Clear property rights provide incentives for

owners to investment in improving their property. However, according to the *Doing Business Report* (2014), Honduras ranks 81st in the Registering Property Indicator, while the WEF Global Competitiveness Report ranks Honduras 98th in the Property Rights Indicator.

Institutional and Regulatory Challenges

Honduras has made progress in reducing the cost of doing business and expediting administrative procedures. These advancements have focused on different investment-climate fronts: the ease of starting a business, simplification of tax payments, the ease of getting credit, property registration and construction permits. Reforms led, among other things, to an impressive reduction in time spent on different administrative procedures. According to *Doing Business*, while in 2006 it took more than 60 days to open a business, it now takes only 14 days. The number of days to deal with construction permits was halved from 165 in 2006 to 82 days in 2015. Time spent to register property also decreased from 35 to 22 days. The number of hours per year it takes for an average firm to pay taxes was also halved from 424 in 2006 to 224 in 2015.

Nevertheless, despite this important progress, a substantial regulatory burden continues to constrain Honduras' business environment. Competitiveness in Honduras continues to lag internationally. According to the 2015 Global Competitiveness Index, which pools 144 countries, Honduras ranks 101st, the lowest in the Central America region. The *Doing Business* report ranks Honduras 104th out of 189 countries, and the OECD Product Market Regulation (PMR) indicators rank Honduras 45th out of 48 countries. Honduras also ranks poorly in firm governance and transparency (174th out of 189 countries), the ease of enforcing local commercial contracts (166th), the simplification of the administrative burden and cost of paying taxes (153rd), the ability to deal with insolvency chapters and secure recovery (140th), the cost for launching new enterprises (138th) and the time and cost to access electricity (110th).

Although Honduras was among the first countries in the region to introduce a Competition Law, evidence suggests that the country's regulatory environment is more restrictive to competition than peer economies (figure 3.28). For example, the OECD's PMR indicator suggests that PMRs in Honduras are less conducive to competition than in most countries in LAC.¹⁸ Regulation restricts competition mainly through barriers to entrepreneurship (complex regulatory procedures) and state intervention in markets. Levels of public ownership and involvement in Honduras in business operations are higher than all LAC countries included in the PMR index, except for Argentina and Jamaica. Moreover, the complexity of regulatory procedures (in particular license and permits systems), administrative burdens for sole proprietor firms and barriers in network sectors remain high. The extent of restrictiveness in PMRs is reflected in the perception that few business groups dominate in the market. Honduras ranks 83rd out of 144 countries in terms of the "extent of market dominance" in the 2015 Global Competitiveness Report, and scores low in the effectiveness of anti-monopoly policy. Honduras has recently adopted a legal provision that allows for a leniency program, which could increase the effectiveness of its efforts to prevent price-fixing or other forms of cartelization, as it enables the authorities to shield cooperating firms from prosecution.

By directly participating via its state-owned enterprises and by fixing market variables, the Honduran government intervenes in markets where competition would otherwise be viable and efficient (figure 3.29). Despite extensive direct government participation in markets (including in markets that are typically served by only private enterprises throughout LAC), there are no adequate rules in place to ensure that state involvement in the economy is neutral to competition. Furthermore, the Honduran government enables competitors (producers and industrial processors) to establish "agreements" (*convenios*) on prices, domestic and import quantities and market quotas for some agricultural products.

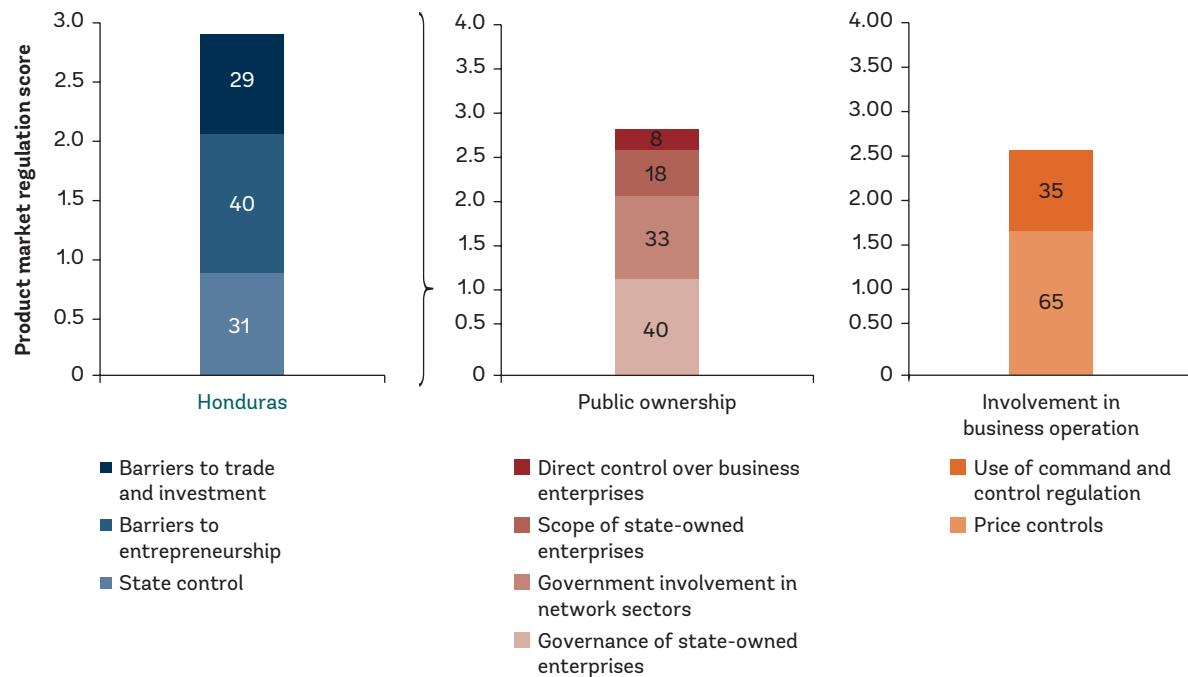
Additionally, a quota is set for new importers of basic grains, deterring market entry. Honduras controls prices for products that are not usually under government control in LAC countries such as freight transport.

In the service sector, regulations often protect incumbents, and administrative barriers inhibit competition (figure 3.30). For example, transport associations are consulted on the entry of new market players, constituting an anticompetitive barrier to entry in a key sector, and the accountancy profession has an exclusive right to provide nine different businesses services for which it sets minimum prices.¹⁹ There is no "silence is consent" rule in place for any sector, increasing the complexity of the procedures to obtain licenses and permits.

The government also maintains special tax regimes for specific products or industries that can distort the allocation of investment. Special regimes, including tax incentives, create an uneven playing field that can distort investment allocation. Benefits include tax incentives for banana production and the tourism industry, free-zone regimes for exports, agricultural export zones, industrial export processing zones and even tax holidays for the fast food industry (box 3.4). Moreover, tax exemptions and exclusive economic benefits hinder government revenues and the capacity of the state to transfer resources to achieve shared prosperity. According to the Revenue Agency, a complex list of exemptions represented over 6 percent of GDP in 2014, with over 68 laws and 11 presidential decrees creating tax exemptions, each with a specific policy goal aimed at stimulating economic growth through a particular sector. In some cases, these tax exemptions are concentrated on a somewhat reduced number of beneficiaries, as is the case with exemptions on the tax to support road infrastructure, with 12 firms accounting for over 77 percent of the total sum of the exemption. Furthermore, it is worth noting that despite the presence of high tax expenditures, Honduras ranks 131 out of 144 countries in the "effect of taxation on incentives to invest" ranking in the 2015 Global Competitiveness Report.

FIGURE 3.28 Government Intervention in Markets Hinders Competition

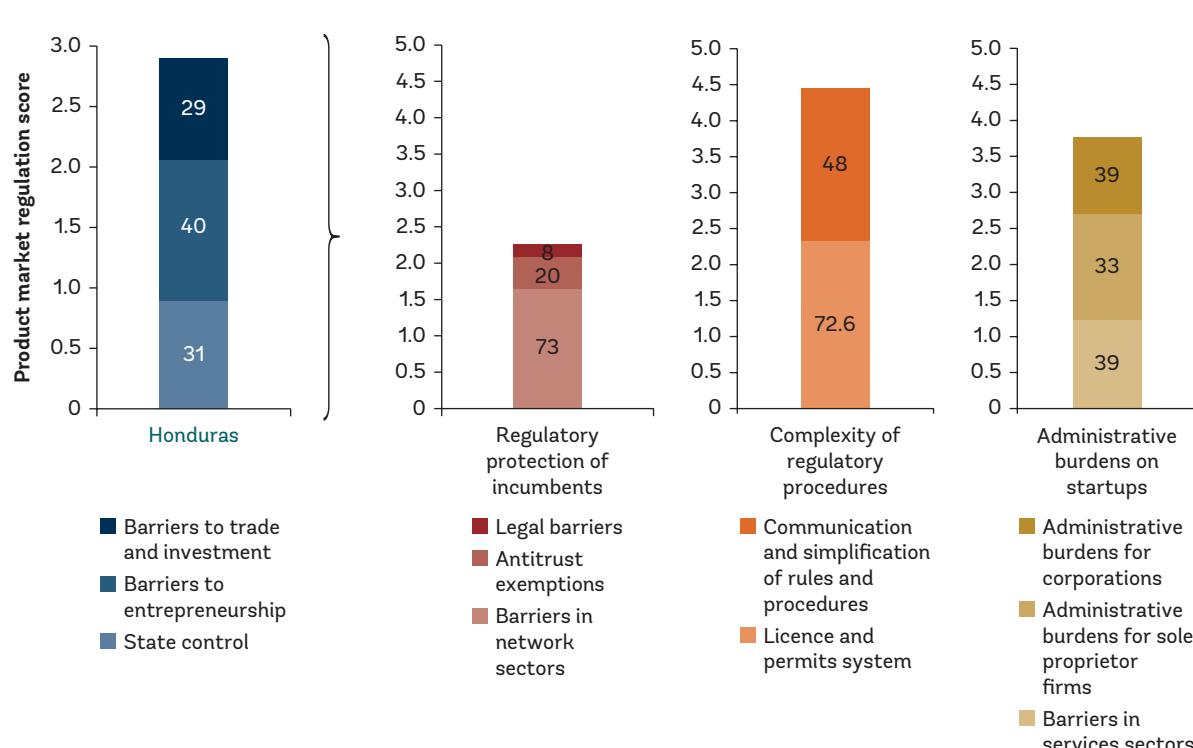
(OECD Product Market Regulation Indicator; decomposition of restrictions to competition through state control)



Source: World Bank Group/OECD PMR data 2013–14.

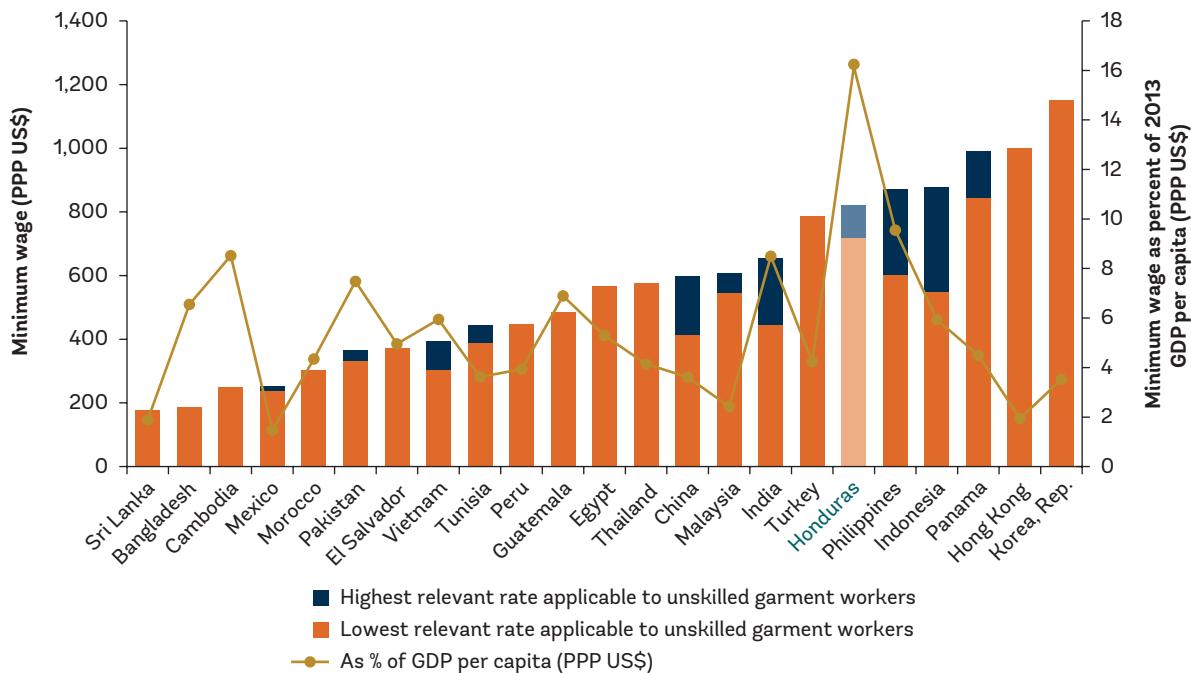
FIGURE 3.29 Regulations Often Protect Incumbents, and Administrative Barriers Inhibit Competition, Particularly in Services Sectors

(OECD Product Market Regulation Indicator; decomposition of main barriers to entrepreneurship)



Source: World Bank Group/OECD PMR data 2013–14.

FIGURE 3.30 Labor Costs in Honduras Are Higher than in Many Other Apparel-Exporting Countries
(Minimum salary in the garment industry and ratio of minimum salary to GDP per capita, 2014)



Source: ILO and World Bank estimates.

As a consequence of higher formal labor costs, the country has experienced a loss of competitiveness; this is evidenced in the manufacturing sector, which has been a driver of poverty changes in the past decade. The textile industry, which represented more than 40 percent of exports in 2013 in Honduras, is struggling with higher labor costs in an international context with more competitive wages in many other textile-producing countries (figure 3.30). Among the top apparel exporters to the U.S., Honduras has the sixth highest wage in the industry, almost doubling the wages of nearby competitors Guatemala and El Salvador, and significantly higher than China, Cambodia, Vietnam, Mexico or India. Possibly as a consequence of high wages, employment in the *maquila* sector has not returned to pre-crisis (and pre-minimum-wage increase) levels.

High minimum wages not only affect the competitiveness of the economy, but also influence the pattern of job creation in Honduras.²⁰ Since the 1970s minimum salaries have been high relative to Honduras' GDP per capita (see appendix H). At the beginning of the decade,

minimum salaries in Honduras were similar to those of Nicaragua and El Salvador and lower than in Panama and Costa Rica. After the increases in 2009, these minimum salaries rose to levels closer to those in Panama and higher than Nicaragua and El Salvador. At the same time, Honduran law offers some of the most generous severance payment policies in the region, further increasing the cost of formal labor. These result of the minimum salary wage hikes and generous severance payments may disincentivize the creation of formal employment. As already noted, only twenty percent of jobs are in the formal sector and self-employment accounts for more than four out of ten jobs in Honduras, the highest share in Central America, and has been the main driver of recent job growth, accounting for 212,000 of the 230,000 jobs created between 2011 and 2013. While there are many factors at play, including a large unskilled pool of workers and a large rural sector, the country's labor market regulations imply a significant cost differential between hiring informal and formal workers.

BOX 3.4 Examples of Special Regimens and Fiscal Benefits in Honduras

<i>Law</i>	<i>Fiscal benefits^a</i>	<i>Sector data</i>
Temporary Import Regime—RIT.	Temporary suspension of payment of customs duties and sales taxes, from imports of inputs to produce goods exported to non-Central American countries.	Number of companies in the regime (2013): 290 Exports: US\$ 1,694M ^b Direct employment: 73,151 ^b
Free Zones Regime—ZOLI	Imports to Free Zones are exempt from tariffs, taxes, duties and other levies. Sales and production within the Free Zone are exempt from payment of municipal taxes. Profits are exempt from the income tax. Companies can sell goods in Honduras if they pay taxes	Number of companies in the regime (2013): 741 Exports: US\$ 6,571M ^c Direct employment: 117,678 ^c
Law of Tourism incentives	No income tax for 10 years from the beginning of operations. Tax breaks on: <ul style="list-style-type: none">• Imports necessary for the construction and initiation of operations• Printed material for promotion• Replacement for impairment of goods• Imports of new vehicles• Imports of aircraft, maritime or waterway transport	
Law of Incentives to the Banana Production	The export company pays the independent producer for every 40 pound box of bananas from rehabilitated and replanted areas US\$ 0.50 during the first three years and US\$ 0.30 for the next three years These payments to independent producers are recognize as expenses in the calculation of the exporter's taxable income	

a. According to Decree 278-2013 Ley de Ordenamiento de las Finanzas Públicas, Control de las Exoneraciones y Medidas Antievasión, Article 23, all fiscal benefits will expire in 12 years, in the case where the law that created them did not stipulate an expiration period.

b. RIT 2013 information based on affidavit—declaración jurada—of 194 companies.

c. ZOLI 2013 information based on affidavit—declaración jurada—of 305 companies.

Sources: Osmel Mangano et al. Partners or Creditors? Attracting foreign investment and productive development to Central America and the Dominican Republic, IDB.

Interviews and information provided by Secretaría de Desarrollo Económico, Dirección General de Regímenes Económicos.

KNOWLEDGE GAP What Is the Effect of Labor Market Regulations on Job Creation, Informal Employment and Unemployment in Honduras?

Formal employment in Honduras is heavily regulated; these regulations may contribute to the high rate of informality by restricting the ability of firms to adjust their workforce. Evidence that these rigidities in regulation may hurt job creation is seen in the creation of 177,000 new jobs after the passage of the Hourly Employment Law of 2010, which allowed for the temporary hiring of workers for specific tasks at an hourly or daily rate.

Notes

1. These refers to the weighted average of the percentage of years between 1975 and 2013 in which a country has exhibited a year-on-year growth rate change of more than 80 percent.
2. Measured at US\$4 per day in purchasing-power parity terms.
3. See chapter 4 for more discussion on wage gaps.
4. This may be due in part to the fact that money transfer firms are a relatively low cost option, as banks charge an average of 4.6 percent for transfers of US\$200. World Bank (2015d).
5. Plan de Turismo Sostenible 2011–14, Instituto Hondureño de Turismo, 2011.
6. It is projected that these new investments will generate about 4,600 new jobs by the end of 2015.
7. This assumes that remittances are exogenous to 18–24 percent, if the models correct for reverse causality in which real exchange rates also affect remittances. See Lopez, Molina, and Bussolo (2008). Other studies finding evidence of Dutch disease resulting from remittances include: Bourdet and Falck (2006); Amuedo-Dorantes and Pozo (2004); Lartey, Mandelman, and Acosta (2012); Vargas-Silva (2009); and Bayangos and Jansen (2011).
8. See chapter 5 for more discussion regarding fiscal sustainability.
9. Returns to secondary education in Honduras, for example, are twice as high as in Costa Rica.
10. See chapter 5 for a more detailed discussion of *ninis*.
11. Levels are also the lower than most Central American countries: Panama (9.3 years), Costa Rica (8 years), El Salvador (7.8 years) and Nicaragua (6.6 years) (EdStats using Barro and Lee).
12. Similarly, Honduras may be able to tap into developments of liquefied natural gas in El Salvador or Panama, projects currently in the pipeline, if excesses are sold regionally.
13. Small firms are defined as having fewer than 20 workers, medium firms as having between 20 and 100, and large firms as having 100 or more.
14. As of 2013, CAR was 14.5 percent, NPLs 3.4 percent, provisioning to NPL 123.7 percent. Currency mismatches by borrowers remain a source of risk within the banking sector. One-third of bank deposits and lending is in foreign currency and mismatches are significant with about 45 percent of foreign currency credit going to unhedged borrowers.
15. FinStats (March 2015). The bulk of the credit is based on consumption credit growing from 15 percent in 2009 to 22 percent in 2013 and 28 percent of credit growth is based on construction and real estate. There is rapid private credit to deposit at 113.9 percent which is well above the regional average of 85 percent.
16. See chapter 5 for more detail on land access in Honduras.
17. Land Governance Assessment Framework. Property Institute.
18. The indicator is divided in three sub-indicators: barriers to trade and investment, barriers to entrepreneurship and state control. The ranking takes values from 0 to 6, and a higher value is associated with regulations more restrictive to competition. Source: World Bank Group/OECD PMR data 2013–14.
19. Ley Orgánica del Colegio de peritos mercantiles y Contadores Públicos de Honduras (Art. 2.14, 7.8)
20. See chapter 4 for further discussion on minimum salaries.

Chapter 4

Equity, Equality, and Social Inclusion in Honduras

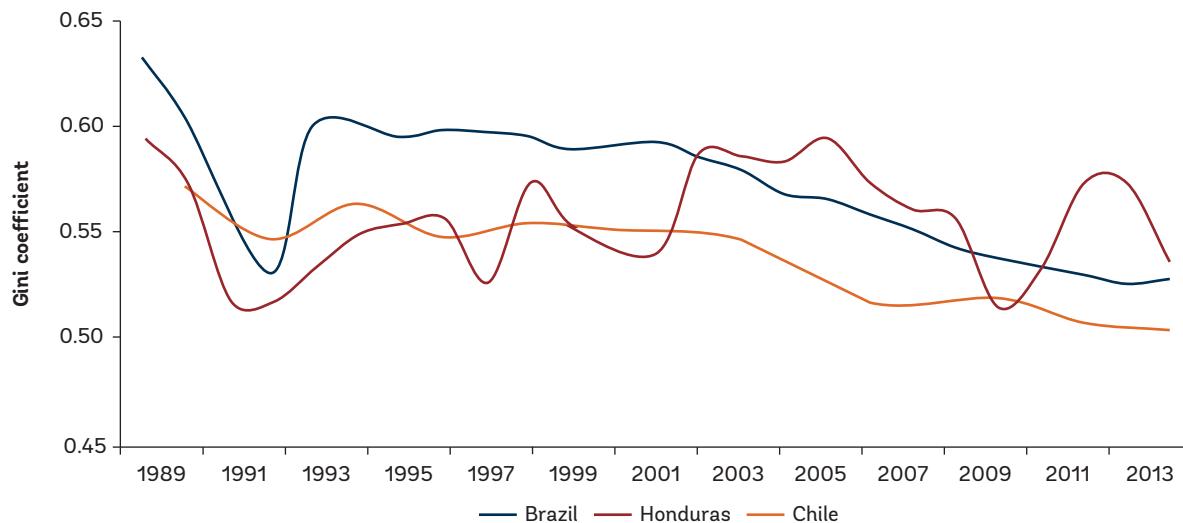
Honduras' potential for inclusive growth is limited by unequal access to basic services, slow job creation and inefficient public spending. Ineffective targeting mechanisms, weak expenditure controls and inadequate institutional capacity distort the distribution of basic goods and services in ways that disadvantage the country's poor. A lack of access to social and economic infrastructure not only diminishes the quality of life among households in the bottom quintiles, it also reduces their employment opportunities and earnings potential, perpetuating entrenched intergenerational poverty. Weak targeting mechanisms, limited budget flexibility, and a weak public accountability framework reduce the efficiency, equity and impact of public spending in Honduras. A lack of opportunities to build human capital has left many Hondurans unable to compete for high-productivity employment, concentrating workers in low-productivity employment, causing high unemployment among certain groups, and discouraging labor force participation, particularly among women.

Honduras has long been among the most unequal countries in Latin America, and while income inequality has fluctuated over the last two decades, little progress has been sustained. In 1990 Honduras' Gini coefficient (0.57) was the same as Chile's, and both were close to that of Brazil (0.60), the most unequal country in LAC at the time (figure 4.1). Yet, while the region as a whole has experienced a substantial reduction in inequality, with inequality in Brazil and Chile falling substantially since the mid-1990s, Honduras' Gini coefficient has fluctuated dramatically and remained high overall, reflecting the intense vulnerability of Honduran

households at the lower end of the income distribution. By 2013 the Gini coefficient was only marginally lower at 0.54, the second-highest level of income inequality in Latin America. Moreover, while the regional middle class has continued to grow, the distribution of income in Honduras remains highly bimodal. High levels of income inequality have constrained poverty reduction in Honduras, even during periods of robust growth.

Underlying the country's long-term inequality are institutional weaknesses which have resulted in unequal access to public goods and services, as well as opportunities to build human capital. A lack of access to education, health care, utilities, public economic infrastructure and private markets has increased the vulnerability of millions of Hondurans exposed to shocks. Moreover, low levels of socioeconomic inclusion leave many poorer households unable to benefit from all but the most robust periods of growth. Constraints on human capital formation have particularly important implications for growth and inequality. Children's access to basic education and health services is largely determined by the income and location of the household into which they are born, systematically limiting human capital formation among the less well-off. Low levels of human capital force workers into low-productivity employment, diminishing their earnings potential and curtailing the opportunities available to subsequent generations. Structural institutional weaknesses reduce the effectiveness of public spending, constraining the ability of policymakers to break the cycle of limited opportunities and low productivity.

FIGURE 4.1 Income Inequality in Honduras Is Both High and Volatile
(Gini coefficient, Honduras, Brazil and Chile, 1989–2013)



Source: World Bank calculations using PovcalNet.

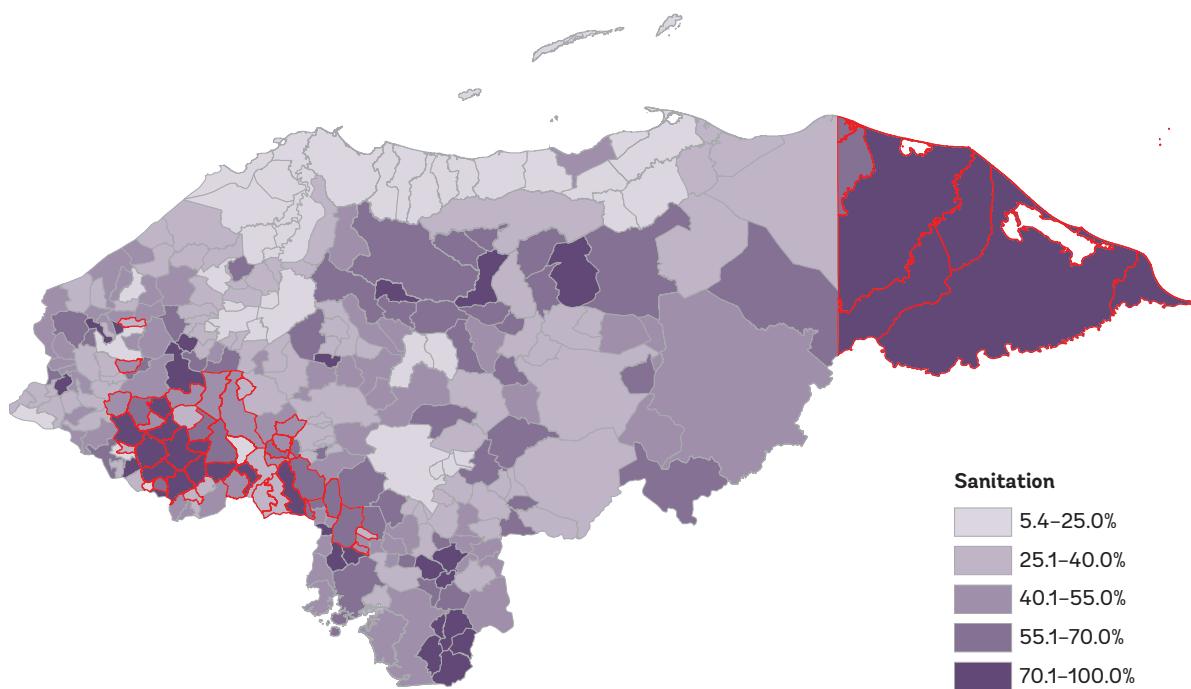
4.1 Limited and Unequal Access to Basic Services

Malnutrition and limited access to basic services are a barrier to strengthening human capital in Honduras. Approximately one out of five Honduran children suffers from chronic malnutrition, affecting the country's human capital. Studies have shown that malnutrition is estimated to be responsible for approximately 45 percent of under-five mortality Black et al. (2013), stunting, in particular, is estimated to contribute to gross domestic product (GDP) losses of up to 11 percent (Horton and Steckel 2013). Children who escape undernutrition are more likely to survive and stay in school; for example, stunted children have at least one year less of schooling than a healthy child (Martorell et al. 2010). Moreover, healthy and better nourished children are 33 percent more likely to escape poverty as adults and earn at least 20 percent more than adults who were stunted as children (Grantham-McGregor et al. 2007). Women who escape undernutrition are also 10 percent more likely to own their own business.

A lack of improved water and sanitation services is associated with more missed school days and poor health outcomes in both children and adults. Higher maternal mortality rates, higher levels of environmental contamination and exposure to a wide range of debilitating and often fatal diseases are linked to poor water and sanitation systems (World Health Organization, UN-Water 2014). While the coverage of water supply and sanitation services is gradually increasing, the distribution of access remains highly unequal, and service quality is generally low (map 4.1 and figure 4.2). In 2013, 14.4 percent of Hondurans—over a quarter of a million households—lacked access to a water grid, and 580,000 households lacked improved sanitation services, mostly in rural areas.¹ The urban poor also suffer from lack of access, as investment has been insufficient to keep pace with the country's rapid urbanization. As a result, a smaller share of the urban population has access to water systems now than in 1990 (World Bank 2014a). Quality varies widely, service interruptions are common and water is frequently rationed. Poor water and sanitation infrastructure in schools exacerbates inequality in education access, as 80 percent of urban schools

MAP 4.1 Access to Sanitation Is Especially Limited in More Remote Parts of the Country

(Share of households without improved sanitation by municipality, 2013)

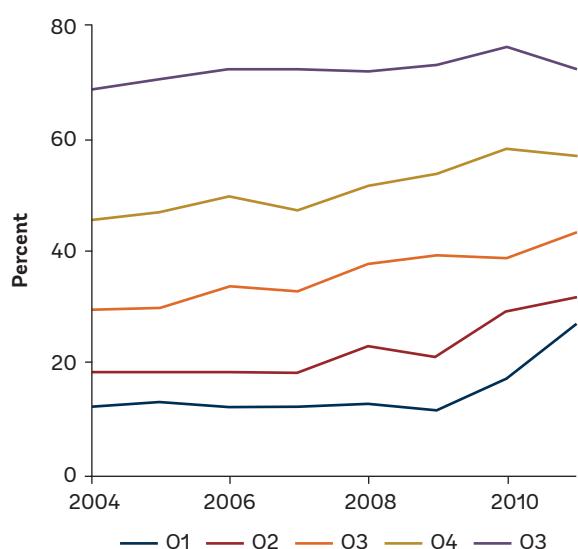


Source: World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.

Note: Areas that are majority Indigenous Peoples and Afro-descendant are outlined in red.

FIGURE 4.2 Access to Flush Toilets Varies across Income Groups

(Access to flush toilets by income quintile)



Source: MAPAS HN Country Report, 2014, CONASA.

have access to improved sanitation facilities, compared to just 62 percent in rural areas. This leaves approximately 500,000 children without access to potable water and 1.1 million children without access to basic sanitation, with deeply negative impacts on health and education outcomes. Similarly, access to these services appears especially limited among indigenous groups. The Economic Commission for Latin America and the Caribbean (ECLAC/CEPAL) estimates that 48 percent of indigenous households have limited access to improved water and sanitation services.

Access to health services remains a key challenge, especially for poor and rural households (World Bank 2015b). While immunization rates have improved, rates of prenatal care provided by a doctor and deliveries assisted by a health professional are uneven. In 2012, 93.5 percent of pregnant women in urban areas received prenatal care from a doctor, compared to just

62.3 percent in rural areas. This gap reflects an even larger disparity between the top and bottom income quintiles, at 97 and 53 percent, respectively. The rate of deliveries assisted by a health-care professional was similarly unbalanced, at 98 percent for the highest quintile and 58 percent for the lowest. Access to health insurance is limited for both the urban and rural populations, covering just 19 percent and 5 percent, respectively. This contributes to Honduras' high out-of-pocket health costs, which exceed both the LAC and Central American averages. These costs further limit healthcare access among poor households, as evidenced by the 2012 National Survey of Living Conditions (*Encuesta Nacional de Condiciones de Vida*). Of the 60 percent of respondents in the poorest quintile who reported being sick during the survey period, 25 percent did not seek medical attention due to cost and 22 percent due to the distance to the nearest healthcare provider.² Moreover, the departments with the largest indigenous populations also have the worst health indicators, reflecting further disparities in access to health services across the country.

Electrification rates in Honduras lag those of other countries in the region; service quality is unreliable, and access is especially limited in rural areas.³ Despite high rates of public spending on the electricity sector, 1.1 million Hondurans lacked access to electricity in 2012, including a quarter of the rural population (International Energy Agency 2014). Low electrification rates reduce living standards in rural areas, increase health and safety risks, and diminish employment opportunities by slowing local economic growth and inhibiting diversification.

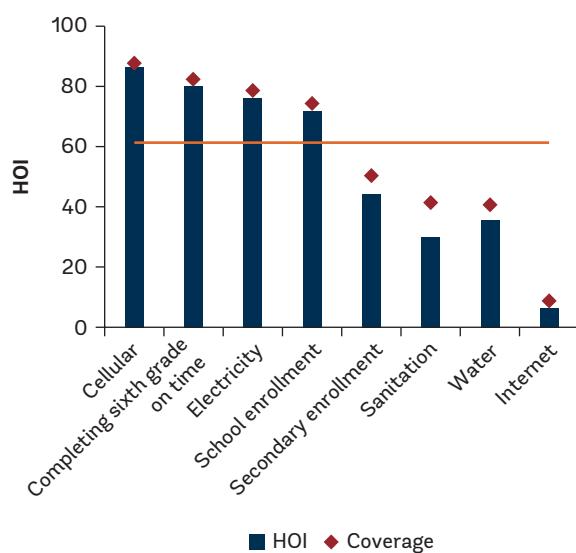
In Honduras, rural status, parental education and household income largely determine children's access to services. The Human Opportunity Index (HOI) examines the correlation between access to services and household characteristics. The HOI is an equity-adjusted measure that captures the degree to which access would need to be reallocated to achieve full equality across a given set of characteristics.⁴ The HOI's equity-adjusted level of access to water and sanitation reveals that,

to equalize access, approximately 20 percent of water coverage and over 30 percent of sanitation coverage in Honduras would need to be redistributed across groups (figure 4.3). The D-Index disaggregated by household characteristics indicates that rural/urban location, income level and parental education largely explain inequality in access to most basic services (figure 4.4). These factors contribute to entrenched poverty, as inadequate access to opportunities in one generation creates the conditions for similar deprivation in the next.

Both Access to Education and Education Quality Remain Low and Unequally Distributed

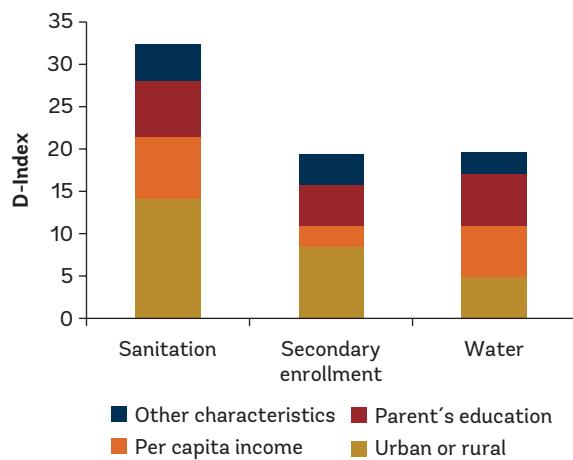
Deep and persistent disparities in education access are a structural barrier to long-term poverty reduction. While Honduras has made progress in expanding access to primary education, enrollment in other levels (pre-primary, secondary and tertiary) remains low, and the quality of public

FIGURE 4.3 Fewer than Half of Honduran Children Have Access to Improved Sanitation or Running Water
(*Childhood access and Human Opportunity Index, 2013*)



Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank).

FIGURE 4.4 Inequality in Children's Access to Services Is Largely Based on Rural Status, Parents' Education and Income Level
(D-Index decomposition of children's access to basic services, 2013)



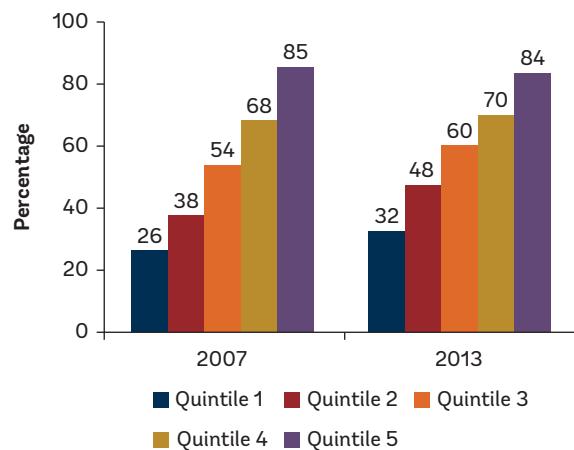
Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank).

Note: This figure reports the dissimilarity index (D-index). The following characteristics are reported under "Other characteristics": gender of the child, gender of the household head, the presence of both parents in the home, and number of siblings. Of these, number of siblings accounts for half of the D-Index.

education presents a serious challenge in both urban and rural areas. Overall access to secondary schooling is heavily influenced by area of residence, parental education and household income level, all of which present barriers to intergenerational mobility. The HOI reveals that the key factors influencing secondary school enrollment are the education of the head of household, the per capita income of the household and its rural or urban location. Enrollment in tertiary education remains low at just 20 percent. In addition, boys are less likely to remain in secondary and tertiary education. In 2013, female enrollment in tertiary education exceeded male enrollment by 6.5 percentage points.⁵

Indigenous peoples have less access to education than other groups. Due to data limitations the HOI cannot be disaggregated by ethnicity in order to estimate the extent of exclusion among minority groups. However other analyses suggest that indigenous communities in particular have lower access than other groups. In 2013, approximately 18 percent of Hondurans over the

FIGURE 4.5 Higher Income Groups Have Significantly Better Access to Secondary School
(Secondary gross enrolment by quintile 2007–13)

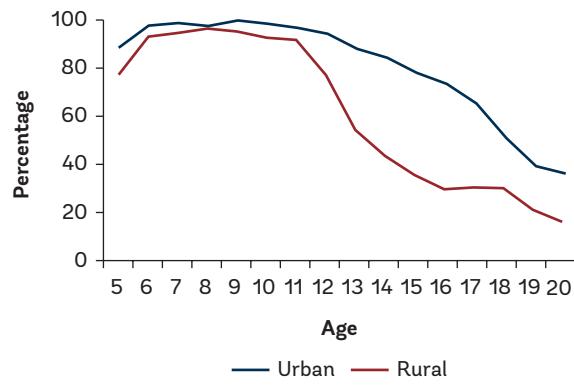


Source: World Bank 2015b.

age of 25 were illiterate; however, the Maya, Chortí, Tolupán, Tawahka, Nahua and Pech had even higher rates than the average for rural areas, ranging from 24 to 34 percent.⁶ A lack of schools in the areas where they live, difficulties attending schools in neighboring non-indigenous communities, deficient school infrastructure and low education quality are the main factors contributing to high illiteracy rates.

A growing gap between rural and urban areas has increased disparities in education access over the last decade. Among the factors driving unequal education rates between urban and rural areas are the poor quality of the Honduras' public school system, low estimates by parents of the returns to schooling, and financial constraints.⁷ Differences in rural and urban enrollment rates magnify the impact of income inequality, and the richest quintiles have nearly twice the school attendance rates as the poorest quintiles, (figure 4.5). While rural enrollment rates have increased in recent years, these improvements have been limited to the lower grades (figure 4.6). Due to an acute shortage of rural secondary schools the rural secondary enrollment rate is half the urban rate. Assuming that the 192 rural secondary schools operating in 2012 were already at full capacity, a staggering

FIGURE 4.6 A Significant Share of Rural Students Do Not Transition to Secondary School
(Honduras urban-rural enrollment, ages 5–20, 2013)



Source: World Bank 2015b.

1,079 additional schools would be required to serve all rural students.

Driven by economic constraints, Honduras has the highest secondary dropout rate in Central America.⁸ In 2013, there was a relatively small difference in primary enrollment rates across Central America, but the trend diverges rapidly at the secondary level, with Costa Rica and Panama recording the highest enrollment rates at around 75 percent and Honduras the lowest at 46 percent. Moreover, Honduras is the only country in Central America where the majority of students cite economic constraints as their main reason for dropping out. In 2013, 53 percent reported economic constraints as the main factor, while only 29 and 14 percent cited a lack of interest in studying or access to schooling, respectively (Adelman and Szekely 2015). While boys and girls drop out at roughly the same rates, their reasons for dropping out differ: for boys economic reasons are most important, while girls are more likely to cite other reasons, including responsibility for household tasks. High dropout rates have important consequences for economic productivity and future inequality. In an effort to address this issue, compulsory education has recently been extended through lower secondary school (up to 9th grade), and secondary education has

been added as a condition of the *Bono Vida Mejor* program.

Education quality is low in both urban and rural areas. National and international tests indicate that the majority of Honduran students do not achieve grade-appropriate literacy and numeracy.⁹ Performance in grades 7–9 is particularly poor, with only 37–42 percent of students reaching a satisfactory level in reading and just 3–8 percent in mathematics (figure 4.7). National standardized test scores reveal no significant differences in educational outcomes between students in rural and urban areas. However, since rural enrollment rates are much lower than urban rates, the rural sample may be biased towards students that are more committed to remaining in school.

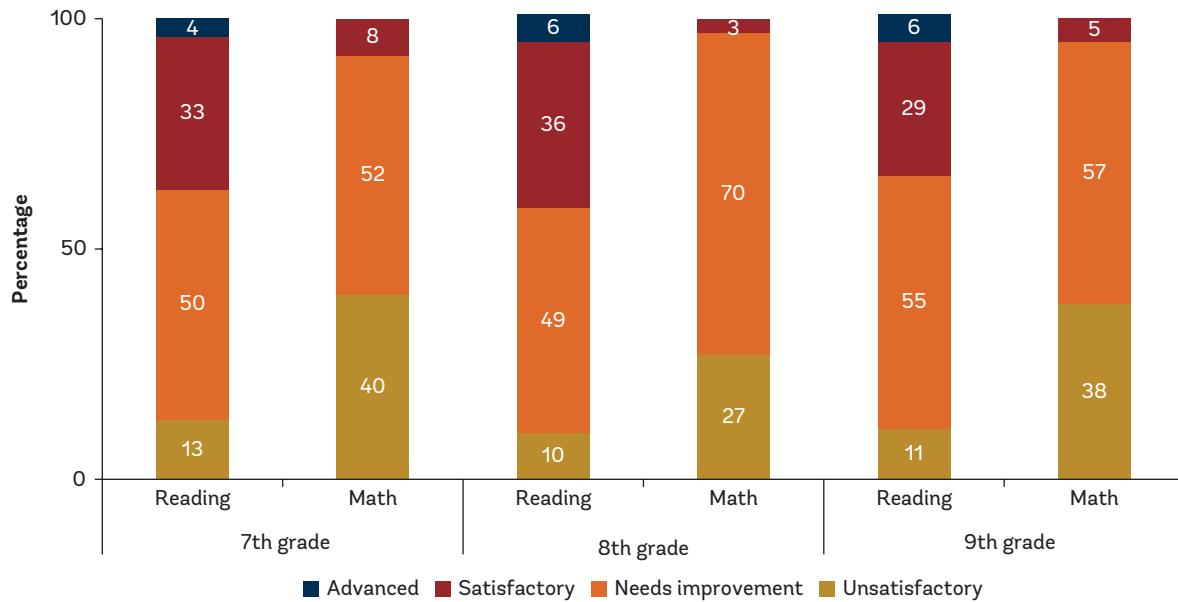
The low quality of public education in Honduras leads wealthier families to opt out of the public school system. While 88 percent of Honduran children attend public schools, the 12 percent that enroll in private school are disproportionately likely to come from higher income households (figure 4.8). This difference is largest at the secondary and tertiary levels. In the urban school system, 30 percent of secondary students and 38 percent of tertiary students attend a private institution, compared to just 13 percent at the pre-primary level and 9 percent at the primary level.

4.2 Lack of Opportunities in the Labor Market

Limited and inequitably distributed access to education, health and public utilities inhibits human capital formation, leaving many Hondurans unable to compete for high-productivity jobs. Honduras suffers from low rates of labor force participation, particularly among women, high unemployment among certain groups, especially young people, and a large concentration of workers in low-productivity jobs.

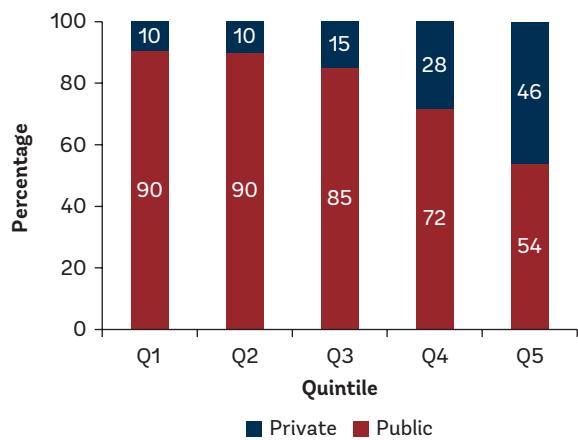
Honduras' labor force participation rate has increased in the last decade, yet it remains among

FIGURE 4.7 Education Quality Remains Low
(Percentage of students by performance level, reading and mathematics, 7th–9th grade, 2013)



Source: World Bank 2015b.

FIGURE 4.8 Higher-Income Households Opt Out of the Public School System
(Urban attendance rate, ages 13–18, by type of school and income quintiles, 2013)



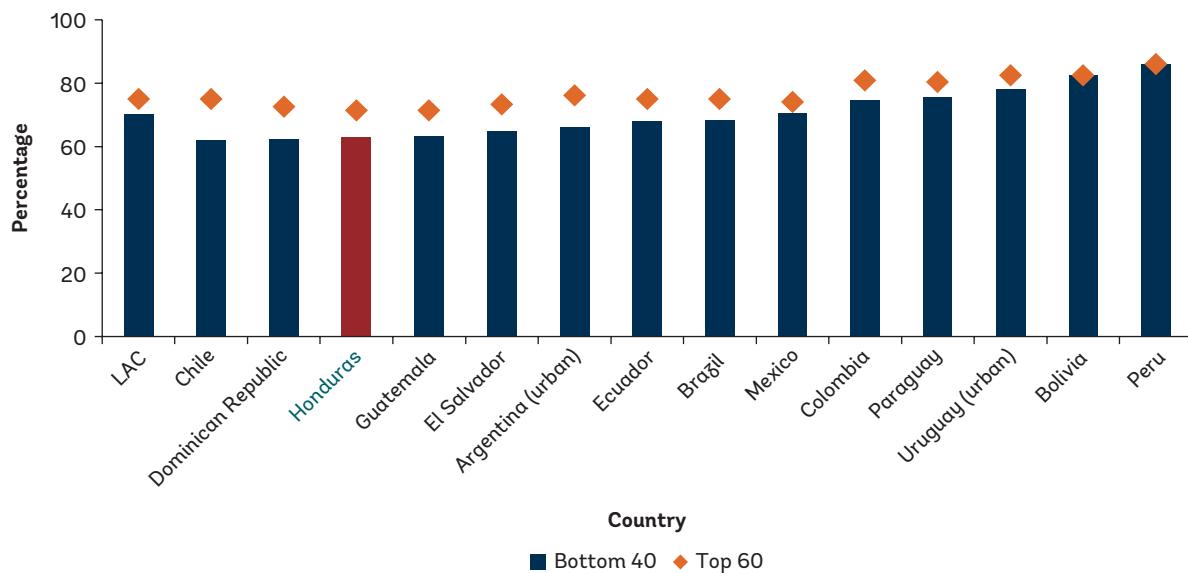
Source: World Bank 2015b.

the lowest in the region, and fewer than two of every three adults in the bottom 40 percent of the income distribution are active in the labor force. The labor force participation rate among adults age 25–55 is just 72 percent, well below the LAC average of 81 percent (figure 4.9). As in most

countries in the region, workers in the bottom 40 percent have lower participation rates than those in the top 60 percent. However, in Honduras labor force participation among workers in the bottom 40 percent has been growing at a faster rate than in the top 60 percent. Between 2003 and 2013, labor force participation among the former increased by over 5 percentage points, compared to 2 percentage points for the latter.

Honduras' unemployment rate is higher than many of its Central American neighbors, and unemployment is most common among women and youth. While the overall unemployment rate of 6 percent is not exceptionally high by international standards, it is elevated by the standards of regional comparators, particularly El Salvador, which recorded an unemployment rate of just 3.8 percent in 2013. As is often the case, unemployment in Honduras is largely an urban phenomenon and is particularly acute among the youngest workers. In 2013, the unemployment rate for workers aged 15–24 was 9.8 percent. Unemployment is higher among women than men, and this gap has grown since 2007, when the two rates were practically the same. The

FIGURE 4.9 Labor Force Participation in Honduras Is Low by Regional Standards, Especially among Workers in the Bottom 40 Percent of the Income Distribution
(Labor force participation rates by country and income group, 2013)



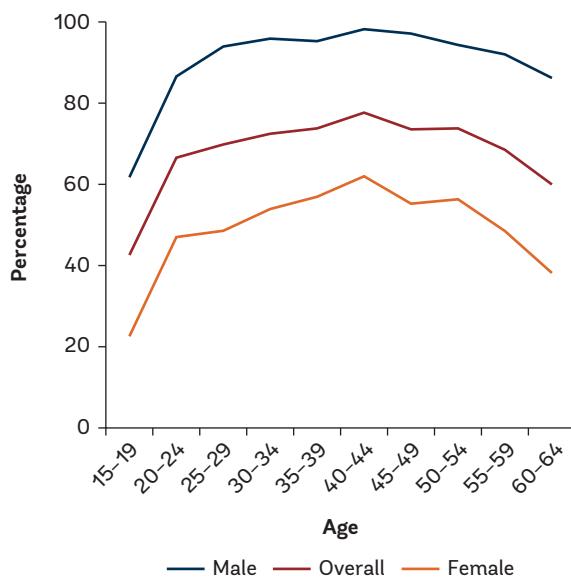
Source: World Bank 2015e.

Note: This analysis is limited to adults ages 25–55 and based on harmonized household surveys to increase comparability across countries.

female unemployment rate is now 3 percentage points higher than the male rate, with the highest rates among women between the ages of 15 and 24. The unemployment rate for young women is estimated to be 13 percent in rural areas and nearly 18 percent in urban centers.

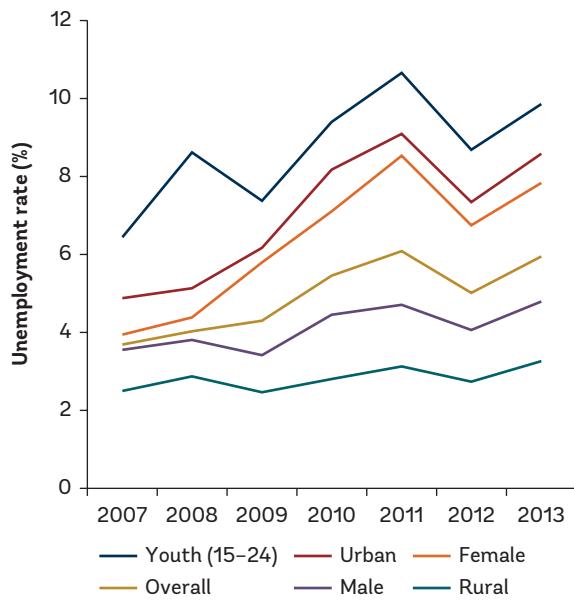
High youth unemployment rates are a particularly serious concern. One fifth of Hondurans are between the ages of 15 and 24, and this group comprises a third of the working-age population. Yet young people face high rates of unemployment, low rates of labor force participation and low rates of school enrollment (figures 4.10 and 4.11). Among young workers who are employed, low job quality is a serious issue. In 2013, fully a quarter of all jobs held by workers aged 15–24 were unpaid family work, with similar rates for men and women. The difficulty of acquiring a quality education and a general lack of jobs discourages young workers from building the skills required by a competitive labor market.

FIGURE 4.10 Women and Young People Are Less Likely to Participate in the Labor Force
(Labor force participation rate by gender and age, 2013)



Source: World Bank estimates using EPHPM.

FIGURE 4.11 Unemployment Is Especially High in Urban Areas and among Women and Youth
(Unemployment rate for select groups, 2007–13)



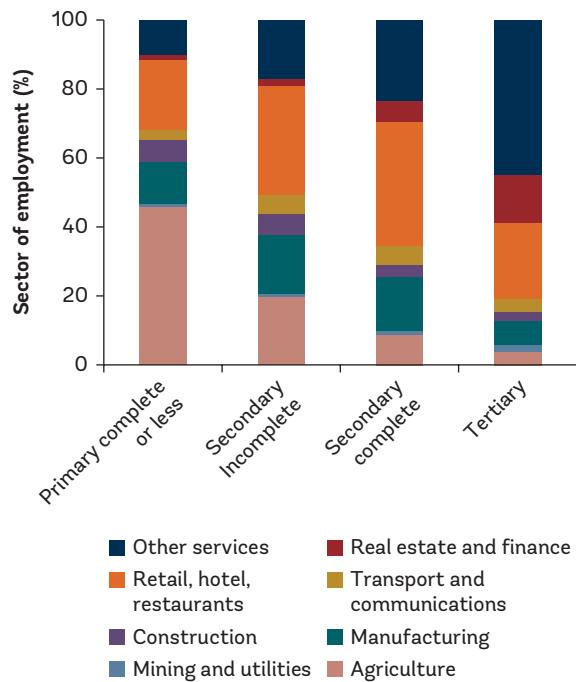
Source: World Bank estimates using EPHPM.

Note: Rates are for workers aged 15–64 unless otherwise noted.

Low Rates of Educational Attainment Are Linked with Low-Productivity Employment

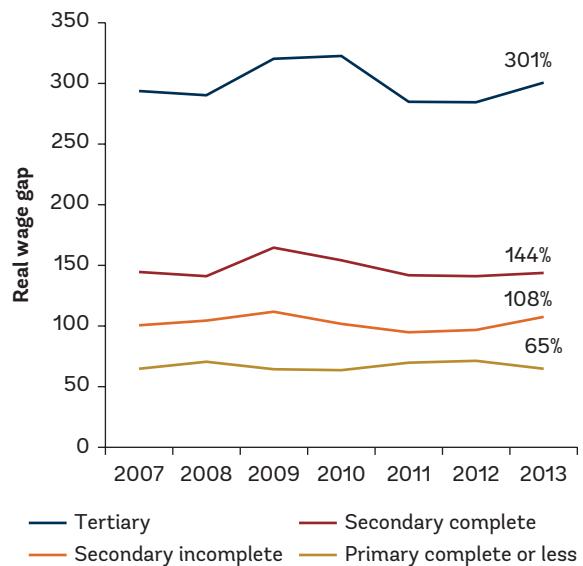
Limited and inequitable access to education translates into disadvantages in the labor market. Almost half of workers who did not attend secondary school work in agriculture, while 20 percent work in the retail, hotel and restaurants sector and 12 percent in manufacturing (figure 4.12). Highly skilled workers are more likely to work in services and less likely to work in agriculture. There are substantial wage disparities in the labor market, both by economic sector and skill level. Workers with a tertiary education earn about 300 percent more than the average wage, while those with primary school education or less earn only 65 percent of the average (figure 4.13). This disparity perpetuates Honduras' high rate of economic inequality.

FIGURE 4.12 The Least-Skilled Work Largely in Agriculture
(Sector by education group, 2013)



Source: World Bank estimates based on EPHPM.

FIGURE 4.13 There Is a High Premium for Workers with Tertiary Education
(Wage gap by education group, 2007–13)



Source: World Bank estimates based on EPHPM.

While the labor market should be expected to reward workforce skills, the small size of the Honduran formal sector and the country's relatively high minimum wage exacerbate the gap in earnings between workers with different levels of education (box 4.1). At approximately US\$600 per month in 2011 purchasing-power parity (PPP) terms, Honduras has a higher minimum wage than Uruguay, Brazil and Chile, and at 13.5 percent, it is the highest in the region as a share of per capita GDP (figure 4.14).¹⁰ Before the

large increase in minimum wage in 2008, formal sector workers earned nearly 30 percent more than informal workers, but by 2013 the wage gap had widened to 65 percent. Yet informal employment dominates the Honduran labor market, and only one fifth of workers are employed in the formal sector. Formal employment not only offers higher average wages, but also access to employment benefits, including one of the most generous severance payment policy in the region (equivalent to a month's salary per

KNOWLEDGE GAP What Is the Impact of the Country's High Minimum Salaries on Job Creation, Particularly for Unskilled Workers?

Economic research has found evidence that high minimum salaries deter the creation of employment, and jobs requiring low skills are the most likely to be affected. Evidence suggests that the minimum salary increase has led to a widening earnings gap between formal and informal workers in Honduras. However, no analysis has yet measured the impact of this policy change in terms of lost employment in the formal and informal sectors.

BOX 4.1 The Minimum Salary and Inequality

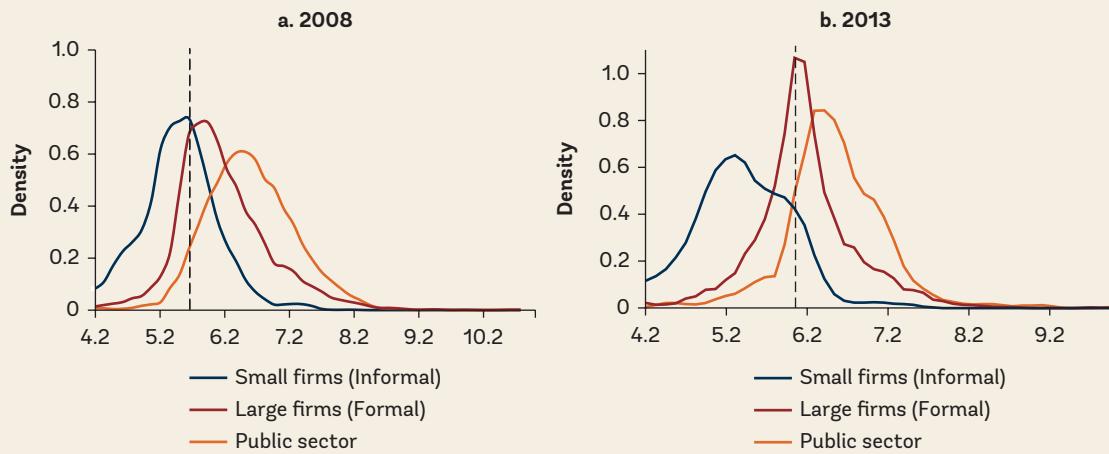
The large gap between the minimum salary and the average wage in the labor market limits the extent to which the minimum wage can influence wages in the informal sector. In 2008 the minimum wage for most formal sector workers was increased by 60 percent, and it now significantly exceeds the average wage in the economy as a whole. Though they are not enforceable in the informal sector, minimum wages often operate as a strong pay signal by indicating what is considered "fair" or "adequate" compensation.^a This effect can be observed in the wage distribution of workers in countries like Brazil and Colombia, for example (World Bank 2015e). However, evidence suggests that in Honduras, setting the minimum wage too high has weakened its effect on the informal sector (figure B4.1.1). The informal wage distribution shifted when the minimum wage was raised. In 2013, 62 percent of informal workers earned less than 90 percent of the minimum wage, down from 47 percent in 2008. By contrast, more modest increases in Brazil's minimum wage between 2005 and 2006 (15 and 17 percent, respectively) did not affect the share of informal sector workers earning less than the minimum. This may be due to Brazil's minimum wage being closer to the average wage.

Minimum wages in Honduras are set by sector, and the low minimum wage for agricultural workers—who are among the poorest in the country—may be widening the overall wage gap. Between 2003 and 2013, the average minimum wage grew by 225 percent in nominal terms, but the agricultural sector's minimum wage increased by just 159 percent. Meanwhile, the gap between the wages of agricultural workers and workers in all other sectors widened. In 2003, the *maquila*, utilities and financial sectors all had minimum salaries that were 123 percent higher than the agricultural sector. By 2013 all sectors of the Honduran economy had minimum wages that were at least 134 percent higher than agriculture. Notably, the minimum wage for *maquila* workers fell from the highest in 2003 to the second-lowest in 2013, with only agricultural workers earning less. Even so, the labor costs of the country's *maquilas* are high by international standards.^b

box continues next page

BOX 4.1 continued

FIGURE B4.1.1 High Minimum Wages Act as Weak Signals for the Informal Sector
(Kernel density distribution of wages by employer type, 2008 and 2013)



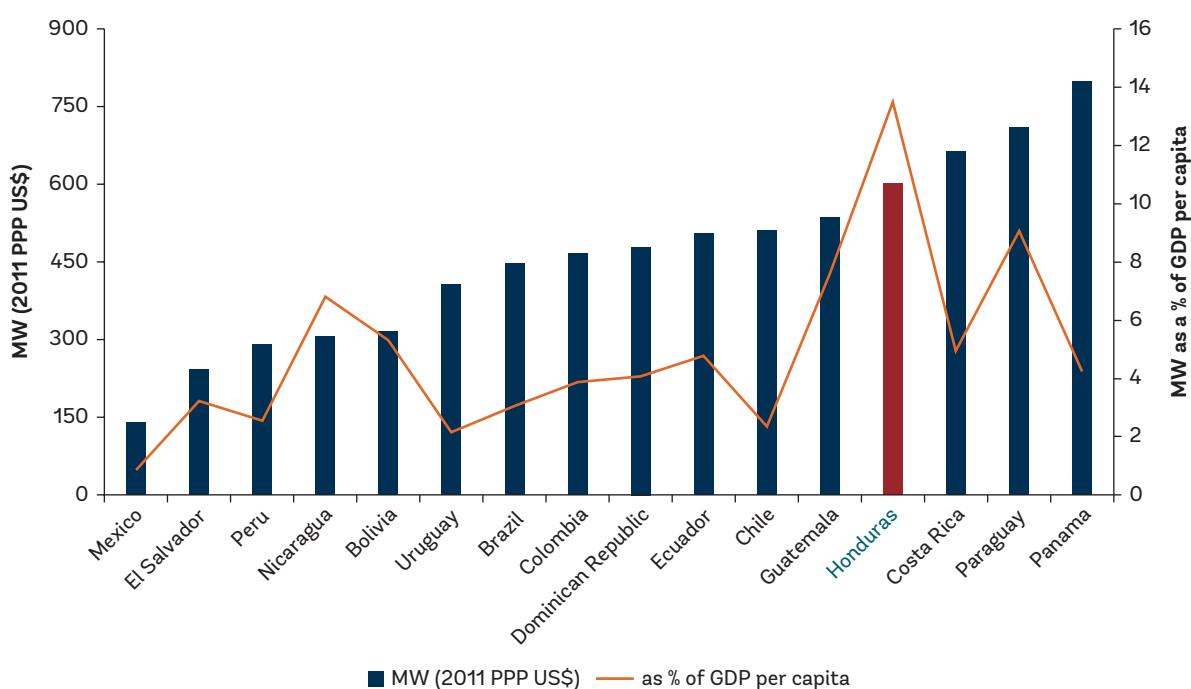
Source: World Bank tabulations using SEDLAC (CEDLAS and the World Bank).

Note: These figures present kernel density plots for public sector workers, informal (proxied by firms employing 5 or fewer workers) and formal workers (proxied by firms employing more than 5 workers). The vertical line represents the minimum salary. The analysis is limited to full-time employees (those who worked between 30 and 50 hours) in urban areas who received wages and excludes the self-employed.

a. “[The minimum wage] is binding if it actually affects wage distribution, whether through enforcement or other factors. It is completely binding if it creates a wage floor, whereas it is somewhat binding if it creates a distortion of the wage distribution, which may not be a wage floor” (Cunningham 2007).

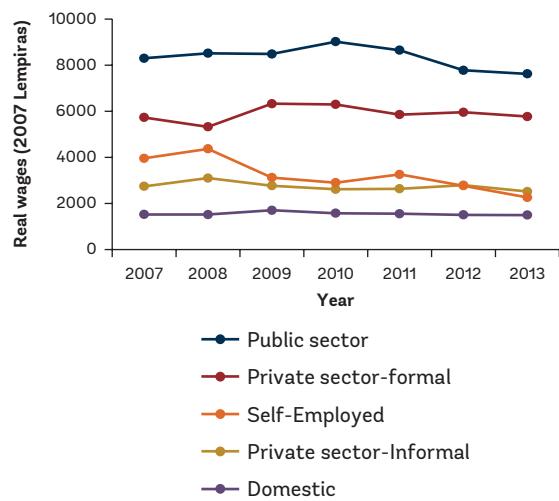
b. See appendix H.

FIGURE 4.14 Honduras Has One of the Highest Minimum Wages in the Region
(Minimum wages as a share of GDP per capita, 2013)



Source: World Bank staff tabulations using the Doing Business database and the World Development Indicators.
Note: Indicators for Nicaragua are based on 2011 figures due to data limitations.

FIGURE 4.15 Public Sector Wages Exceed Private Sector Wages
(Real wages, 2007–13)



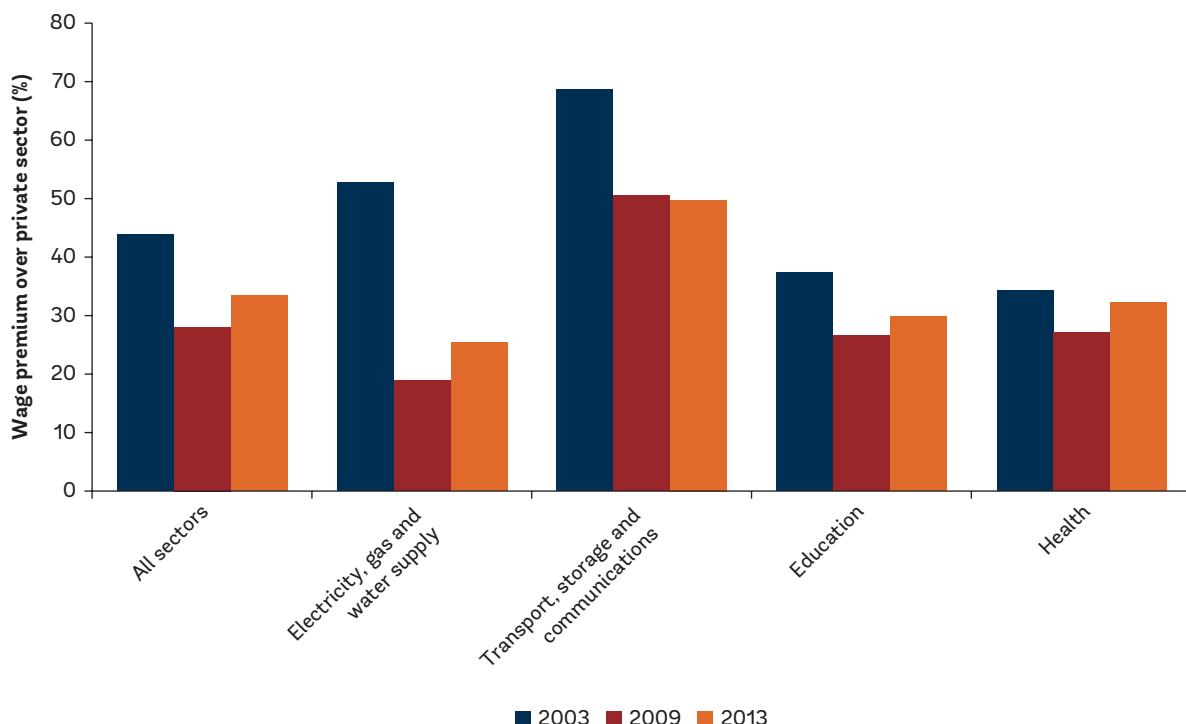
Source: World Bank 2015d.

Note: Real wages are reported in 2007 lempiras.

year worked), and stronger worker protections. Nearly 80 percent of informal workers did not finish secondary school and approximately 40 percent of informal jobs are in agriculture, while only 11 percent are in manufacturing. By contrast, only 3 percent of formal workers are employed in agriculture while 23 percent are in manufacturing.¹¹

The wage gap is also influenced by relatively high public sector salaries, and public sector workers earn more than similarly skilled workers in the formal private sector. In 2013, civil servants earned about a third more than similarly skilled workers in private firms, but this gap fluctuated across sectors (figure 4.15). For example, public transportation workers earned 50 percent more than their private sector counterparts, while the gap was just 25 percent for public utility workers (figure 4.16).

FIGURE 4.16 The Public-Private Wage Gap Varies by Sector
(Public sector wage premium, 2003, 2009 and 2013)



Source: World Bank estimates based on EPHPM.

Note: Public sector wage premiums are estimated using Mincer equations, controlling for education, gender, age, urban status, and regional fixed effects.

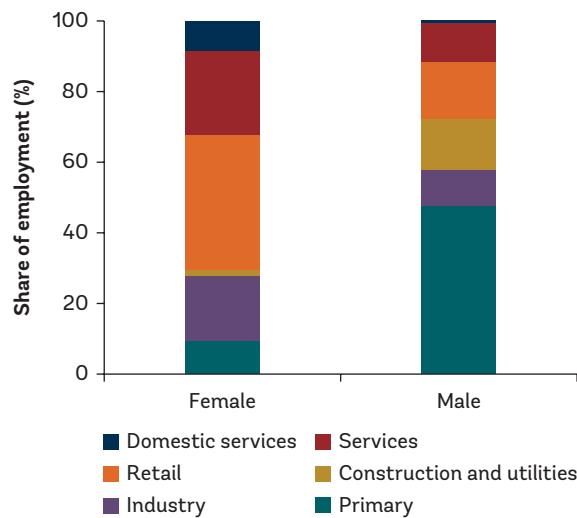
KNOWLEDGE GAP What Are the Challenges Facing Increased Female Inclusion into the Labor Force?

Approximately two thirds of agricultural workers' wives do not report being in the labor force, even though production activities in small farms are typically undertaken by all family members. Low labor force participation rates among women in Honduras may be due in part to the underreporting of women's involvement in agricultural production, food processing and distribution (Dewalt et al. 1985; Colverson 1995). However, traditional gender roles, poverty, lack of access to capital, and violence may be limiting the ability of Honduran women to gainfully enter the labor force.

Weak Labor Market Outcomes for Women

Female labor force participation is especially low in Honduras. At 46 percent Honduras' female labor force participation rate is lower than both the male rate (85 percent) and the female rate for LAC as a whole (53 percent).¹² The gender gap affects Hondurans of all ages, but is particularly significant for the youngest and oldest groups. Lower labor force participation rates reflect the limited employment opportunities available to women, who face higher unemployment rates and lower average wages. The leading sectors for female employment are retail (38 percent) and services (32 percent) including the domestic services subsector, which employs 11 percent of women who did not complete secondary school (figure 4.17). Industry, particularly the *maquila* subsector, accounts for another 18 percent of female employment. However, despite the fact that half of the Honduran population lives in rural areas, the primary sector represents 10 percent of female employment, whereas it accounts for nearly 50 percent of male employment. A lack of employment opportunities for women in the rural economy may partially explain Honduras' relatively low female labor force participation rate. Moreover, due to the enormous amount of domestic labor required by rural households—particularly given their limited access to running water, sanitation, electricity and other basic services—rural women in Honduras may have an unusually high reservation wage.

FIGURE 4.17 Women Are More Likely to Work in Retail and Services, while Men Are More Likely to Work in the Primary Sector
(Employment by gender and sector, 2013)



Source: World Bank estimates based on EPHPM.

Note: For more gender labor market indicators see appendix I.

Traditional gender roles and familial and household obligations reduce female labor force participation. A married rural woman with no children is 18 percent less likely to be in the labor force than an unmarried woman with no children, while a married urban woman is 14 percent less likely than her unmarried counterpart. The reverse is true for men; married men in rural and urban areas are 8 percent and 12 percent more likely to be in the labor force than unmarried men. Each additional child in the household is associated with a 1 percent decrease in female

labor force participation. Honduras' high crime rates may also deter female labor force participation, and women in urban areas with high homicide rates are less likely to be in the labor force.

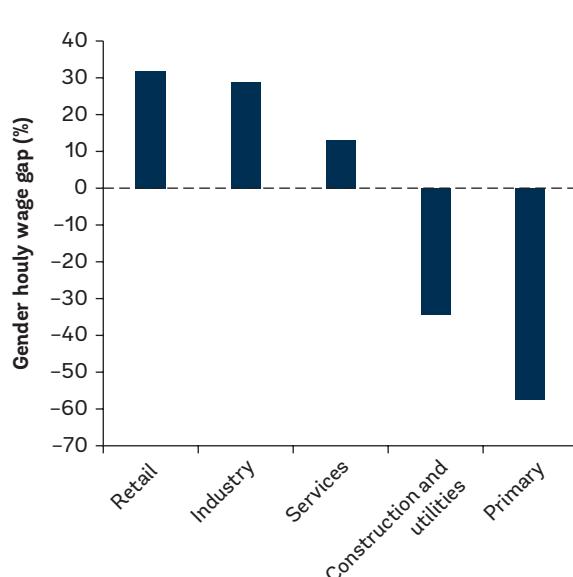
Women with less education are less likely to participate in the labor force and face worse employment outcomes.¹³ The receipt of remittances is correlated with a lower likelihood of being part of the labor force across both the rural and urban sectors, and the link is particularly strong among women. However, education and household characteristics are also closely correlated with labor force participation, particularly for women. *Ceteris paribus*, women with more education are more likely to be in the labor force; urban women who completed primary and secondary school are 6.4 and 19.5 percent more likely, respectively.¹⁴ This explains certain employment outcomes. For example, informality is more prevalent among men in the labor force (85 percent) than women (78 percent), in part because women with the lowest education levels and most limited access to employment are least likely to participate in the labor force.

Even though Honduran women, on average, earn less than men, the gender pay gap has decreased over the last decade. Average hourly wages are higher for men than for women in sectors with higher rates of female participation. As of 2013, men earned nearly a third more than women in retail and industry and 13 percent more in the service sector. However, after adjusting for socioeconomic and labor characteristics it appears that the gender pay gap has moderately improved in the last decade.¹⁵ In 2003, the average wage for male workers was approximately 20 percent higher than for comparable female workers; by 2013 this gap had fallen to 12 percent (figure 4.18).

Further constraining women's opportunities to enter the labor force is a lack of access to finance historically limited by their lack of access to land. Even though the law stipulates that land can be registered under the names of both spouses, in practice cultural norms generally recognize men as the heads of families and

FIGURE 4.18 The Gender Wage Gap Varies by Sector

(Hourly wages, 2013)



Source: World Bank estimates based on EPHPM.

Note: For more gender labor market indicators see appendix I.

landowners. This constrains women's access to financing, as they are less likely to be able to use land as collateral.¹⁶ In Honduras, 35 percent of men have a bank account, compared to less than a quarter of women. In LAC as a whole, male and female bankarization rates are comparable at 49 percent for women and 53 percent for men. Women also face other challenges, as they tend to have less access to training, capital, inputs and markets for their goods. Women are also more likely to tend smaller plots on less fertile soil, and they are less likely to produce export crops than male farmers.

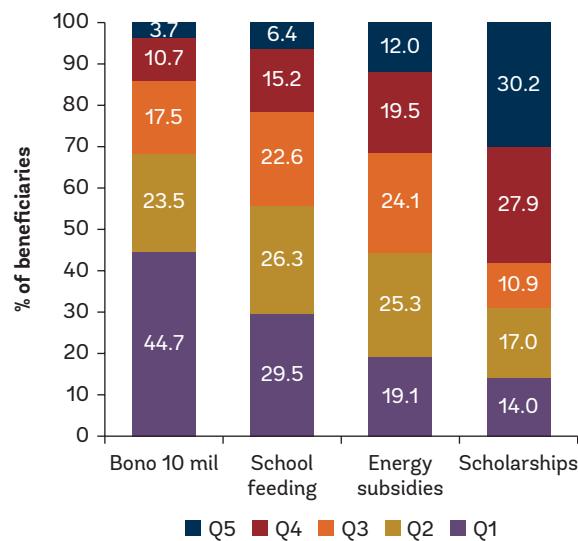
4.3 Challenges to Effective Public Spending

While social spending is relatively high in Honduras, weak institutional capacity hampers the ability of public agencies to deliver quality services that promote inclusive growth. The low quality of public service delivery negatively impacts education, health and workforce skills among the poor, slowing the accumulation of

human capital and perpetuating economic inequality. Poor targeting mechanisms, limited budget flexibility, and a weak accountability framework have been exacerbated by fiscal instability and a lack of budgetary credibility. Finally, inadequate institutional capacity leaves public agencies susceptible to corruption, patronage and various forms of elite capture.

Due to inefficient targeting, a large share of the beneficiaries of social spending are in the top 40 percent of the income distribution. While Honduras' medium- and long-term development strategies provide a degree of policy coordination designed to achieve specific development targets, limited institutional capacity and data limitations diminish the effectiveness of strategic planning. While the *Bono Vida Mejor* program is relatively well targeted, other programs are not. In 2013, households in the top 40 percent of the income distribution received almost 60 percent of spending on scholarships and 22 percent of energy subsidies (figure 4.19). Before they were reformed electricity subsidies effectively covered only the top 62 percent of Honduran households in 2011, creating an unsustainable fiscal burden

FIGURE 4.19 A Significant Share of Public Spending Is Allocated to the Top 60 Percent
(Beneficiary incidence of major social protection programs in Honduras, 2013)



Source: World Bank estimates based on EPHPM using standardized ADePT software (Social Protection Module).

that prompted the redesign of the targeting mechanism. The social security system accounts for a large share of public spending, yet it covers only 20 percent of workers, and its distribution is steeply regressive (box 4.2).

Weaknesses in policy design and limited institutional capacity further reduce the efficiency of public spending and limit inclusive growth. Labor market policies suffer from particularly acute targeting issues. Honduras lacks unemployment insurance or individual savings accounts to protect workers from unemployment risk. While youth unemployment rates are higher than the national average, less than 0.1 percent of GDP is allocated to training programs for unemployed youth (Marques 2010; World Bank 2015b). Instead, most resources go to training already-employed young adults through the National Training Institute (INFOP).¹⁷ As employment status is correlated with income level, spending on workforce training largely benefits wealthier workers. Similarly, the government's employment service (*Empleate*) explicitly excludes informal firms, and as a result most postings are for formal jobs, often requiring secondary or tertiary education. This is a critical targeting weakness considering that less educated individuals face serious information constraints when looking for a job, are generally unable to access job search programs, and comprise both the majority of workers in Honduras and the vast majority of those living in poverty. Honduras also lacks employment-of-last-resort programs to activate during emergencies. However, projects executed by the Social Investment Fund (FHSI) are usually small and community-driven, and they have in some cases offered temporary employment.

High wage bills limit the ability of policymakers to reallocate resources in order to improve service delivery.¹⁸ Trade unions in the public sector have negotiated beneficial labor conditions, especially in the health and education sectors as exemplified by the large share of resources devoted to salaries and favorable tax exemptions (World Bank 2012b).¹⁹ Driven by high minimum salaries and a lack of hiring oversight the public wage bill now represents an estimated 9.1 percent

BOX 4.2 The Social Security System

Though it covers less than 20 percent of workers, the government spends a considerable amount of resources on the social security system. In 2012 the country's social security schemes, most of which operate on a pay-as-you-go contributory mechanism, amounted to 4.6 percent of GDP. The Honduran Social Security Institution (*Instituto Hondureño de Seguridad Social*, IHSS) is the country's largest scheme. It covers formal workers in the private sector and offers health insurance and workers compensation in addition to social security benefits. Separate social security institutions cover public employees (INJUPEMP), teachers (INPREMA), police and military (IPM) and employees of the National University of Honduras (INPREUNAH). The social security regime at IHSS is a defined-benefits system funded by a 3 percent contribution rate with a cap that is currently lower than the minimum wage and therefore insufficient to finance any meaningful social security benefit. The government has made various efforts to reform the country's social security institutions, all of which suffer from actuarial deficits and poor management. The most recent reform was carried out in 2011 at INPREMA and successfully reduced its actuarial deficit from 29 percent of GDP to between 9 and 13 percent.

The IHSS social security regime suffers from structural weaknesses. The IHSS lacks a digitalized history of contributions. When applying for a benefit, the member is asked for a list of his or her former employers, and then IHSS manually reviews the paper records of the employer's historical declarations to establish the history of contributions. IHSS only has a database of affiliates in digital form, some of whom may end up never contributing to the system. Weak information management also limits the information available to project future liabilities and analyze the impact of reform efforts. As a result of low contribution rates and an outdated benefit formula, IHSS members receive low benefits.

Due to its focus on formal sector workers the IHSS is deeply regressive, and the system's regressivity is exacerbated by its use of housing saving accounts. These are individual saving accounts financed through an uncapped contribution of at least 3 percent of salaries. Although all workers in the formal sector contribute to this system, only those who earn more than double the minimum wage (approximately 20 percent of covered workers) are entitled to request mortgage credits backed by this account, making it steeply regressive.

of GDP and accounts for more than half of current expenditures (figure 4.20). Capital investment has declined since 2008, dropping from 2.8 percent of GDP to 1.4 percent in 2012,²⁰ and is expected to fall to 0.9 percent of GDP in 2015. Public sector gross capital formation reached a decade low of 3.3 and 4 percent of GDP in 2010 and 2011, compared to 5 and 6 percent in 2003 and 2004, respectively. In addition, nearly 6 percent of GDP is spent on earmarked transfers, and the establishment of taxes with earmarked revenue further restricts budget flexibility. This has left only a narrow margin for public investment in other areas.

In 2013, nearly 90 percent of education spending was allocated to wages (figure 4.21). By contrast, countries with highly effective education systems usually allocate around 50 percent

of their education budget to teacher salaries. Meanwhile, capital investment amounted to just 0.9 percent of total education spending.²¹ Low levels of capital investment intensify expenditure inequalities by, for example, limiting the ability of education authorities to address the lack of rural secondary schools.

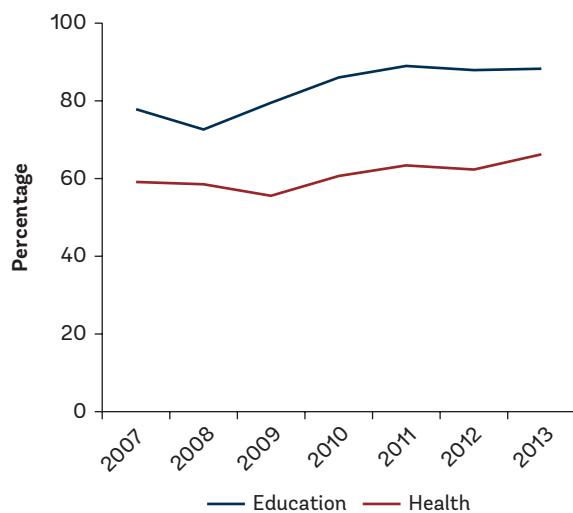
Staffing costs in the state-owned water and sanitation company (SANA) increased by nearly 74 percent in real terms over a 10 year period, while almost no increase was registered in the client base (World Bank 2013b). While a large portion of the budget should be dedicated to maintenance, rehabilitation and replacement costs, there are currently no funding mechanisms designed for this purpose. At the same time, implicit subsidies reduce rates for households with water access, while the poor are left

FIGURE 4.20 Public Salaries Have Risen in Nominal Terms, yet Declined as a Share of GDP
(Central administration salaries as a share of GDP and in millions of lempiras, 2009–15)



Source: Honduran authorities. Figures for 2014 and 2015 are estimated. Government of Honduras "Lineamientos de Política Presupuestaria Plurianual 2015–18." Secretaría de Finanzas.

FIGURE 4.21 The Wage Bill Continues to Dominate the Education and Health Budgets
(Wages as share of sector spending, 2007–13)



Source: World Bank 2015b.

Note: The numbers reported follow the IMF classification of social expenditure.

with little or no service. Inadequate cost recovery impacts service quality through underspending on maintenance and investment, further limiting the scope and quality of water coverage in the country (World Bank 2014a).²²

While public health spending reached almost 3.4 percent of GDP between 2007 and 2012, the wage bill accounted for nearly 66 percent of the sector's expenditure, leaving less than 25 percent for medical supplies and 8 percent for capital investment. The Ministry of Health's average from 2007 to 2012 is higher than the average for middle-income countries (52 percent) (Clements et al. 2010; World Bank 2015b) and higher than in El Salvador (57.4 percent)²³ and Guatemala (48 percent). In the education sector, more recent budgets have decreased the share of the wage bill in total spending. Similarly, the 2014 budget allocated a lower share of health spending to salaries (45.9 percent) and 12.7 percent to capital expenditures.

A weak accountability framework has given rise to fraud, leakages and inefficient staffing, which negatively affect service delivery. In education, for example, ghost workers and teacher absenteeism are recurrent concerns in terms of expenditure control, though recent reforms are beginning to show results (box 4.3). In the health sector, there is evidence that the mismanagement of pharmaceuticals and medical supplies wastes as much as 23 percent of the sector's budget. Weak oversight and management at the central level encourage systemic inefficiency, reducing the effectiveness of public expenditure in a context of fiscal constraints. A public sector personnel registry launched by the government in 2014 enabled the identification of ghost workers and facilitated a thorough analysis of staff qualifications and benefits. The registry also identified nearly 19,000 different positions in the civil service, compared to just 1,200 positions included in the organizational structure of the Civil Service Directorate.

Inadequate controls at the subnational level further increase the share of current spending. A 2013 Public Expenditure Review (PER) revealed that most municipalities do not comply with legal rules for earmarked transfers. Municipalities are required to invest 54–69 percent of the transfers they receive from the central government, and they are allowed to allocate a maximum of 15–30 percent to administrative costs depending

BOX 4.3 The Education System

Poor teacher performance, including high rates of absenteeism, has been a core contributor to the country's low educational outcomes. Although Honduras spends heavily on teachers' wages, both in terms of GDP and as a share of the education budget, its student-teacher ratio is higher than in neighboring countries and twice as high as in comparable countries worldwide. Weak institutional oversight has led to the accumulation of ghost workers, which accounted for 23 percent of the public payroll in 2010.^a In addition, an estimated 60 percent of teachers are not qualified for their position, and only 90 of the 200 official school days are spent on academic tasks (World Bank 2015b). Honduran teachers tend to score poorly on university entrance exams, suggesting negative selection into teaching. Over the last decade the school year has been frequently disrupted by teacher strikes and demonstrations, and between 2002 and 2011 Honduran schools were closed for approximately a third of the total number of class days.^b Even when school is in session, teachers spend an average of just 64 percent of class time on learning activities (SEDUC 2011).

Between 2012 and 2015 the government passed the Fundamental Law of Education, the Higher Education Law and the Law for Strengthening Public Education and Community Participation. These reforms extended the school year by about 25 days to compensate for lost days, and Honduran schools now regularly achieve the 200 school-day mark. In an attempt to increase enrollment in secondary school the targeting formula for *Bono Vida Mejor* was expanded to cover students in lower secondary education as well as primary. The government has also taken steps to ensure the timely payment of teacher salaries, thereby addressing a core complaint of teachers unions, and enacted new regulations designed to curb absenteeism and limit strikes.

The government has also established an Integrated Education Management Information System (EMIS) consolidating student-level, teacher-level and administrative information. The EMIS helped eliminate almost 3,000 ghost workers from the education payroll, saving an estimated US\$20 million annually. The EMIS also helped prioritize capital investment in education through the creation of a sectoral master plan.

a. Due to the inaccuracies of the Ministry of Education database, the true number of ghost teachers cannot be determined, in addition, it is possible that some teachers were actually working in other schools and not included in the sample or were not recorded at the time.

b. Teachers represent about half of all civil servants and are highly organized with a strong union. The World Bank 2007 Country Assistance Strategy (CAS) suggests that much of the school year is lost to teachers' work-stoppages. For further information on teachers' unions in Honduras, see Arcia and Gargiulo 2010.

on the size of the municipality. Yet the PER found an inverse relationship between the ratio of recurrent expenditures to total municipal expenditures and the level of transfer dependence. In addition, the PER also suggests that municipalities use the majority of their own resources to finance personnel and other forms of recurrent spending, rather than capital investment. The absence of ex-ante commitment controls and a lack of predictability in transfers has caused municipalities to commit to future expenditures even when adequate resources are not available.

The government is decentralizing certain functions in an effort to improve efficiency in public

service provision, however this process has been slow and uneven. In the water and sanitation sector, 40 percent of the Honduran population is now served by 61 decentralized urban providers. However, these providers have limited access to financing and often suffer from low managerial capacity. Meanwhile, SANAA still operates 13 major urban systems covering 1.5 million people. In the health sector, the decentralized model for primary care now reaches 1.2 million people in 69 municipalities. Yet the questionable financial sustainability of municipal service provision and the weak regulatory capacity of the central government threaten recent progress. Limited institutional capacity at

both the central and local levels leaves many public institutions unable to effectively service their target populations.

Accountability remains a persistent challenge, though recent reforms have yielded positive results. Developments in the health sector underscore both the progress that has been made thus far and the obstacles that must still be overcome. The Ministry of Health is currently allocating its budget based on an action plan linked to specific targets. It has assigned performance-based contracts with decentralized facilities, and it will be piloting performance-based contracts with select public hospitals in the near term, with the goal of extending them to all public hospitals by 2018. The active participation of civil society groups has improved transparency by drawing attention to sector weaknesses and potential reforms. However, serious challenges persist in human resources management, and especially in the procurement and management of pharmaceuticals. Despite an increase in public scrutiny in the wake of a major pharmaceutical procurement scandal, inefficiencies in the health sector continue to negatively impact service quality (World Bank 2015b).

Recent reforms and emerging multi-stakeholder initiatives demonstrate the government's commitment to improving the quality of public administration. The authorities are mounting an aggressive campaign against crime and corruption. In 2013, the government undertook a self-assessment of its compliance with the United Nations Convention on Anti-Corruption (UNCAC), and in 2014, Honduras became the first national government to sign an agreement with Transparency International on anticorruption priorities. The authorities have also taken steps to promote constructive multi-stakeholder engagement through initiatives designed to achieve shared strategic goals. These include the Open Government Partnership (OGP), the Extractive Industries Transparency Initiative (EITI), and the Construction Sector Transparency Initiative (CoST). Key challenges remain in addressing strategic and structural issues, such as ensuring merit-based appointments in audit and oversight institutions, professionalizing the public sector workforce, and strengthening public procurement (box 4.4). Action in each of these areas will be required to sustain recent progress in public administrative reform.

BOX 4.4 Public Procurement in Honduras

Public procurement systems in Honduras suffer from institutional weaknesses, including a lack of clarity in the roles of leading agencies, inadequate staff and funding, and unreliable information systems, which negatively impact the efficiency of public spending. The National Procurement Office (ONCAE) recently launched a new electronic procurement platform (HonduCompras) linked to the public financial management system. However, ONCAE has consistently suffered from high staff turnover and is currently understaffed. This jeopardizes the consolidation of the savings achieved through the implementation of the electronic procurement system, as well as a first set of pilot framework agreements for interinstitutional coordination. The agency is attempting to perform a strategic analysis of public procurement trends and their policy implications, but the success of this work depends on the opening of staff positions in ONCAE by the Civil Service Directorate. During the development of the HonduCompras platform ONCAE lacked the institutional capacity to serve as a counterpart to the software development firm that installed the system. As part of the reorganization of the Executive Branch initiated by the new administration ONCAE was shifted from the Ministry of Finance to the newly created Presidential Directorate for Transparency and Modernization of the State (PDTMS), which has a distinctly different vision regarding the role of ONCAE. The government has also resorted to outsourcing the procurement of medical supplies to UNOPS in an effort to improve transparency and efficiency.

Notes

1. World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.
2. World Bank estimates using 2011/12 ENCOVI.
3. See appendix F for sub-national access rates to electricity, water, and school enrollment.
4. See World Bank (2014b) for further details on the HOI concepts and methodology. Household circumstances included in this analysis are rural/urban status, gender (both of the child and the head of household), parental education, family per capita income, number of siblings, and the presence of both parents in the home.
5. World Bank World Development Indicators.
6. World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.
7. Lopez (2013) shows that the returns to education are higher for tertiary education (118 percent) than for secondary education (29 percent), which in turn offers a higher return than primary education (17 percent).
8. See chapter 3 for more discussion on education in Honduras.
9. See box 3.2 in chapter 3.
10. Based on the 2013 *Doing Business* survey. Both minimum wages and GDP per capita are in 2011 US\$ in PPP terms.
11. See appendixes J–M for more detailed labor market indicators.
12. Honduran participation is calculated for all men and women between the ages of 15 and 64 using the EPHPM. The regional labor force participation rate is from World Bank (2015e).
13. These results are based on linear probability regressions of labor force participation by gender and urban/rural sector for adults aged 25–65. See appendix D for detailed regression results.
14. Among rural women, the correlations are 9 and 30 percent for those who completed primary school and for those who completed secondary school. Given the low school access rates in the rural sector, this may reflect professionals moving to the rural sector for service jobs (schools, health sector), suggesting a highly self-selected group.
15. See appendix G for gender wage gap regression results.
16. Committee on the Elimination of Discrimination against Women (CEDAW), *Combined fourth, fifth and sixth report for States parties: Honduras*, 2006.
17. In 2012, INFOP's budget reached 0.16 percent of GDP, reaching 170,000 individuals, most of them already employed.
18. ICEFI, World Bank. (2013). *Honduras: Ciclo Presupuestario e Índice de Presupuesto Abierto*.
19. For example, Honduran teachers at all education levels do not pay taxes. (See Article 55 of Executive Agreement No.0760-SE-99, Government of Honduras.)
20. World Bank 2013a. *Fiscal Sustainability and Effectiveness of Social Investment in Honduras: Social Sector Expenditure Institutional Review*. Human Development Department. Washington, DC: World Bank.
21. Honduran authorities, 2014 Tabulations: “Cuenta Financiera Segun el Manual Del FMI 1986.”
22. The analysis considers investments, access to water and sanitation and the cost of improved technologies. Countries like Honduras should invest at least one percent of their GDP in water and sanitation, yet between 2002 and 2011 Honduras invested just 0.13 percent. An additional US\$350 million per year would be required for the Honduras to achieve universal access to these services.
23. Ministerio de Salud Pública, El Salvador. (2013).

Chapter 5

Sustainability

Over the past three decades Honduras has repeatedly experienced the same unfortunate pattern, in which gains achieved during periods of relatively robust, broad-based growth are wiped out by an abrupt, devastating shock and then only partially reclaimed during the modest, uneven recovery that follows. These cycles are evident in the country's growth, income and poverty statistics, each of which reveal a gradually improving long-term trend marred by recurring setbacks. Thus, the crucial challenge facing Honduran policymakers is not only to promote economic growth or foster progress in poverty reduction and shared prosperity, but to reinforce the economy's resilience against shocks and sustain income and poverty gains in the face of unpredictable circumstances. Structural sensitivity to economic shocks, chronic fiscal instability, exposure to natural hazards, high levels of crime, violence and corruption, and limited public administrative capacity represent multiple dimensions of vulnerability that together pose a persistent risk to the achievement of Honduras' economic and social development objectives.

5.1 Macroeconomic Sustainability

The economy's sensitivity to a wide range of shocks—internal and external, endogenous and exogenous—is largely responsible for its pattern of growth punctuated by repeated crashes. Honduras' economy is small, open, largely agricultural and predominantly informal. A lack of physical and institutional infrastructure, an adverse business climate, burdensome regulations and high security costs discourage investment, inhibit diversification and slow the reallocation of capital and labor, creating structural rigidities on the supply side. Agricultural output is especially vulnerable to both market

volatility and exogenous shocks, as the sector focuses on a narrow range of primary commodities produced with limited technological support. On the demand side, the growing role of remittance inflows heightens external vulnerability, as remittances are closely tied to the US labor market, especially the services and construction sectors.

Agricultural output is volatile, and the sector has considerable scope for diversification. Honduran farmers are highly vulnerable to weather conditions, including erratic rainfall. Although coffee production has begun to recover following the recent outbreak of rust-leaf disease (*roya*), coffee producers are no more resilient to blights and other natural shocks than they were in 2012. Diversifying the sector by introducing new crops and encouraging investment in agro-processing could boost the sector's exports and enhance its employment and income potential. In particular, increasing export-oriented fruit and vegetable production may provide an opportunity to reduce the overall vulnerability of the sector and increase wages. A recent analysis by the International Food Policy Research Institute (IFPRI) estimated that shifting one third of the area dedicated to corn and beans to higher-value crops such as fruits and vegetables could expand Honduras' economic output by US\$1.1 billion per year, equivalent to 4.4 percent of gross domestic product (GDP). However, many farmers are unwilling or unable to assume the risk of diversification away from staple crops due to the sector's vulnerability to environmental shocks, their own limited access to agricultural credit and insurance mechanisms, and the limited extent of social protection policies and emergency preparedness infrastructure to counter the threat of food insecurity.

Although the contribution of mining to GDP has decreased over the last few decades,

Honduras is now presented with an important opportunity to explore its untapped mineral potential. Currently, there are only seven metallic mines and about 300 non-metallic mines in Honduras. Yet, the country has significant reserves of iron oxide, and there are about 160 pending permit requests for exploration and feasibility studies. The revised Mining Law passed in April 2013 provides an improved framework to promote investment in the sector. In addition, offshore oil exploration is underway, and a commercially viable discovery could improve the trade balance, encourage foreign investment and bolster government revenues, all of which would help to reinforce macroeconomic stability. However, for extractive industries to

effectively promote long-term growth and sustainable social development, appropriate transparency and accountability mechanisms must be in place. In light of Honduras fragile ecology, environmental protection must also be accorded a high priority. Finally, high-value extractable resources have a history of fomenting instability in developing countries, and steps must be taken to ensure that any new resource development does not further undermine the rule of law.

Honduras' macroeconomic profile is expected to improve during 2015–16, as a positive external environment supports critical efforts to strengthen the country's fiscal position and boost economic growth. Table 5.1 presents Honduras' medium-term macroeconomic outlook. Growth

TABLE 5.1 Main Macroeconomic Indicators and Projections in Honduras, 2010–18

	2010	2011	2012	2013	2014e	2015f	2016f	2017f	2018f
Real economy									
GDP	3.7	3.8	4.1	2.8	3.1	3.2	3.2	3.3	3.3
Agriculture and livestock	1.8	6.5	10.7	3.4	2.7	4.4	4.0	3.9	3.9
Mining	-4.0	-10.6	-3.2	-6.9	-5.1	1.3	1.0	1.5	1.5
Manufacturing	4.5	4.4	1.8	3.4	1.5	3.3	4.1	4.1	4.0
Electricity and water	-0.2	3.6	2.9	-2.5	1.3	2.5	2.5	2.5	2.5
Construction	-2.4	4.4	2.4	-2.5	-8.2	0.0	1.0	1.5	1.5
Commerce	3.4	4.2	3.8	2.1	2.0	2.8	2.8	2.8	2.8
Services	4.8	2.9	3.6	3.2	5.0	3.1	3.0	3.0	3.0
Domestic demand	4.4	6.7	2.5	0.6	2.9	5.9	2.8	2.9	3.3
Private consumption	3.6	3.6	4.3	3.8	2.7	8.9	3.7	3.5	3.8
(percent of GDP)	78.1	77.6	78.6	81.3	81.1	77.2	78.6	79.1	78.9
Gross capital formation	12.0	24.1	-2.7	-11.4	6.8	1.7	1.7	1.7	1.9
(percent of GDP)	21.9	26.0	24.6	21.8	22.1	23.1	22.7	22.3	21.8
Exports of goods and services	15.7	8.4	9.8	-1.3	1.6	6.1	1.8	1.8	1.4
(percent of GDP)	45.8	51.3	50.9	48.3	46.9	43.2	40.4	38.1	35.7
Imports of goods and services	15.2	12.7	6.3	-4.1	1.5	10.4	1.4	1.4	1.7
(percent of GDP)	63.7	71.0	70.3	69.3	65.7	58.3	56.0	53.3	50.2
Consumer prices (end of period)	6.5	5.6	5.4	4.9	5.8	4.0	4.0	4.9	4.9
Fiscal accounts									
	(Percent of GDP, unless noted)								
Non-interest revenues and grants	24.1	23.1	22.5	22.9	24.4	25.6	25.9	25.9	26.1
Of which: Tax revenues	15.1	15.4	15.1	15.3	17.3	17.3	17.5	17.5	17.5
Total Non financial expenditures	26.1	24.8	25.4	28.4	26.6	25.4	24.7	24.2	24.0
Current expenditures	20.7	19.0	19.4	22.0	20.7	20.4	19.7	19.2	19.0
Capital expenditures	5.4	5.9	6.0	6.4	6.0	5.0	5.0	5.0	5.1
Primary balance	-2.0	-1.7	-2.9	-5.6	-2.2	0.2	1.1	1.7	2.0
Interest payments	0.9	1.1	1.3	2.0	2.1	3.0	3.1	3.0	3.0
Overall balance	-2.8	-2.8	-4.2	-7.6	-4.3	-2.9	-2.0	-1.3	-1.0

table continues next page

TABLE 5.1 continued

	2010	2011	2012	2013	2014e	2015f	2016f	2017f	2018f
<i>Balance of payments</i>									
Trade balance (billions of US\$)	-2.6	-3.1	-3.0	-3.1	-3.0	-2.7	-2.7	-2.7	-2.7
Trade balance (percent of GDP)	-16.8	-17.9	-16.3	-17.1	-15.7	-13.7	-13.7	-13.7	-13.7
Current account balance (percent of GDP)	-4.3	-8.0	-8.6	-9.6	-7.6	-6.0	-6.0	-5.8	-5.6
International reserves (percent of GDP)	17.3	16.0	13.9	16.6	18.4	19.3	19.8	20.0	19.9

E: estimates, F: forecasts

Source: Honduran authorities and World Bank estimates.

is expected to recover during 2015–18, with all major sectors contributing. The ongoing recovery in coffee production combined with rising yields for other export-oriented crops will bolster the agricultural sector, while continued growth in manufacturing and construction will have an especially positive impact on employment indicators. Increasing investment will boost the credit supply as the financial sector remains solvent, while expanding internet and telecommunications infrastructure will spur growth in services. Finally, lower oil prices are expected to help reduce the current-account deficit. However, this forecast rests on the assumption that current fiscal consolidation efforts will continue to be implemented as part of a broader program of governance reforms, and that past progress will be maintained. Consequently, a sustained political commitment to the reform agenda is critical to the positive outlook presented below.

Strengthening the business climate would facilitate diversification and enhance the economy's ability to adapt to changing circumstances. According to the Fraser Institute's 2014 Survey, Honduras' Investment Attractiveness Index is the lowest in LAC, and the country remains last globally in terms of the Policy Perception Index. Improving how Honduras is perceived by the global private sector would help to attract increased foreign investment and promote the development of new industries. However, macroeconomic growth and resilience are not determined by economic policies alone, but are also profoundly influenced by the fiscal, environmental and social dimensions of sustainability.

5.2 Fiscal Sustainability

The country's fiscal situation is one of its biggest challenges to macroeconomic sustainability, as growing fiscal deficits limit the resources available for public investment, social service provision and environmental protection, and could ultimately push the public debt to unsustainable levels. Achieving fiscal sustainability will be critical to support strong, consistent growth and enduring poverty reduction.

Fiscal consolidation

Substantial imbalances in the public accounts and an unsustainable debt trajectory have at times destabilized the Honduran economy, undermining wealth creation, perpetuating poverty and exacerbating the country's already high degree of inequality. Fiscal instability intensifies poverty in two ways: by causing economic disruptions, with which the poor are least able to cope, and by limiting the fiscal space available for public spending, on which the poor are most likely to depend. Historically, the performance of public finances in Honduras has followed the electoral cycle, with higher fiscal deficits coinciding with presidential and parliamentary elections, making the realigning of the country's fiscal stance more difficult (World Bank 2015a). Even though incoming administrations often announce policies to reduce fiscal deficits, positive results have rarely been sustained.

Honduras continues to run sizeable fiscal deficits despite relatively high revenue inflows, and major expenditure rigidities constrain the available fiscal space for public investment and

social spending. Recent fiscal reforms pushed the central government's current revenue intake to 18.0 percent of GDP in 2014, 91 percent of which came from tax collection. Yet, current revenues only slightly exceeded current expenditures, which reached 17.9 percent of GDP and accounted for around 78 percent of total public spending. This reflected a modest decline in current expenditures from 20 percent of GDP in 2013 due to a decrease in transfers and purchases of goods and services. However, the expansion of the public debt stock has caused interest payments and interest rates to rapidly increase. Interest payments on public debt reached 2 percent of GDP in 2013 and rose to 2.3 percent just a year later. Similarly, the total public debt stock increased from US\$8.3 billion in 2013 to US\$9.3 billion in 2014. The rise in debt service is limiting the resources available for social spending and investment. Social spending has declined as a share of GDP from 18.8 percent in 2008 to 15.3 percent in 2012, with the largest reductions concentrated in education (which fell from 6.9 percent of GDP to 4.6 percent) and social security (7.3–5.9 percent).

The state-owned electricity company (ENEE) has played a major role in the persistence of the public sector deficit. In 2014, ENEE recorded losses over US\$1 million per day, equivalent to 1.3 percent of GDP. This was a decrease from the 1.8 percent of GDP observed in 2013, but still above the government's target. Though energy sector reforms were implemented in 2014, the reduction in ENEE's deficit was mainly a consequence of falling international oil prices. ENEE's weak financial position is caused by its below-cost tariff structure combined with subsidies and high technical losses (i.e. poor utility infrastructure) and non-technical losses (i.e. weak commercial management, theft and fraud). Even though public spending on electricity is relatively high, access to electricity remains limited. Moreover, the transfers necessary to cover ENEE's deficit come at the expense of public investment in productive sectors and core infrastructure, with a clear impact on economic growth.

The public sector wage bill and the pension system have been critical contributors to fiscal

instability over the past decade. Honduras' public sector wage bill is among the highest in LAC and has increased substantially since 2001, reaching 12.7 percent of GDP in 2013 before moderating slightly in 2014. The health and education sectors account for almost 70 percent of the total wage bill and have been the main drivers behind its recent expansion. Education alone accounts for more than 50 percent, and the teachers' union is one of the most politically active groups in the country.¹ At 5.1 percent of GDP Honduras' relative pension spending is the highest in Central America and one of the highest in Latin America at well above the regional average of 3.3 percent. Yet all social security institutions combined cover less than 20 percent of the employed population. Efforts have been made to reform these institutions, but these efforts are hindered by a lack of fiscal space and institutional weakness in the management of the pension system. These challenges are exacerbated by a poor information-management system, a lack of reliable beneficiary data, low average benefit levels and a highly regressive distribution of benefits.

Since December 2013 the authorities have launched a set of reforms designed to open new fiscal space in an effort to overcome Honduras' legacy of chronic fiscal instability. The fiscal consolidation agenda addresses both revenues and expenditures (box 5.1). The authorities have taken steps to boost tax revenues, tighten controls over current expenditures by strengthening payroll and procurement oversight, and reduce losses in the electricity sector. Meanwhile, additional measures are being implemented to improve the targeting, monitoring and evaluation of social protection programs in order to enhance the cost-effectiveness of social spending.

The fiscal reform program is designed not only to rectify imbalances in the public accounts, but to bolster confidence in the economy as a whole. Efforts to improve the government's revenue position, limit the growth of current expenditures and mitigate the fiscal risks posed by state-owned enterprises would establish the foundation for more robust long-term growth, though the consolidation might have a temporarily

BOX 5.1 Recent Measures Aimed at Reducing the Fiscal Deficit

Tax policy and tax administration. Key tax policy measures include: (a) an increase in the VAT rate from 12 to 15 percent, bringing it slightly above the LAC average of 14 percent; (b) the elimination of selected VAT import and income tax exemptions; (c) the reduction of the minimum tax-exemption threshold for the income tax; and (d) an increase in the average fuel tax by about US\$0.25 per gallon (excluding fuel used for electricity generation). The authorities are restructuring the Revenue Authority by: (a) strengthening the Large Taxpayers Unit (LTU); and (b) modernizing the DEI's IT system.

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

Power sector: To reduce ENEE's structural deficit, electricity tariffs were increased by 12 percent in October 2014 and by a further 9 percent in December 2014. Electricity subsidies were eliminated for those consuming more than 75 kWh per month. A new Electricity Law was adopted in 2014 which (a) defines sector responsibilities under the Ministry of Industry and Commerce; (b) creates a new Electricity Regulatory Commission responsible for defining methodologies for establishing tariffs and technical standards as well as overseeing transparency in bidding processes; (c) allows private sector participation in transmission and distribution; (d) establishes an Independent Market Operator to develop generation contracts and guarantee supply adequacy; and (e) restructures ENEE into a holding company with subsidiaries for generation, transmission, and distribution in order to improve accountability and cost efficiency, and reduce cross subsidies. In 2015 ENEE's wage bill was reduced by 40 percent, reducing its deficit by 0.25 percent of GDP.

Public financial management: Supported by a Fiscal Emergency Law the government has begun streamlining the public sector through: (a) nominal wage freezes in 2014 and 2015, and (b) the elimination of 60 percent of positions that were unfilled at end-2013. As a result, the non-financial public sector wage bill declined by 1.4 percent of GDP in 2014, though the full impact of the reform will only materialize over the medium-term due to the cost of severance payments. A public employment census was completed in 2014, and public sector employees are now recorded in a central database integrated with the automated payroll system. To enhance the scope of public-private partnerships (PPPs) the authorities have: (a) introduced a PPP framework law creating a fiscal risk unit within the Ministry of Finance; and (b) repealed the law allowing government guarantees for debt contracted by companies involved in PPP projects. The government has also implemented measures to enhance procurement mechanisms, including the adoption of an e-procurement law and the signing of shared services agreements to eliminate duplicate procurement functions.

State-owned enterprises: The government adopted a plan to restore the medium-term financial sustainability of the state telephone company (HONDUTEL) by (a) appointing a new administration in 2014 with a plan to reduce the number of business units by half; (b) reducing non-essential spending, including a 35 percent reduction in the workforce, limiting overtime hours, curbing outsourcing and decreasing energy consumption; (c) improving network efficiency and enhancing maintenance and monitoring mechanisms; and (d) building a strategic partnership with a private company to provide bundled services.

Monetary, exchange rate, and financial sector policies: The authorities adopted a multiyear plan to recapitalize the Central Bank through non-negotiable bonds bearing a positive real interest rate, and the central bank has implemented short-term liquidity-management policy. The Central Bank is also taking advantage of the flexible exchange-rate regime, allowing the Honduran lempira to depreciate by 5 percent during 2015. Financial sector reforms include: (a) stricter regulations aimed at reducing exposure to currency mismatches by unhedged borrowers, (b) stronger pension fund investment policies designed to protect resources and maintain adequate returns, (c) the passage of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) legislation.

negative effect on growth in the short term. The overall public sector deficit is expected to decline from 7.6 percent of GDP in 2013 to 2.2 percent by end-2016, supported by a combination of revenue and expenditure measures. On the revenue side, tax reforms are expected to increase the tax-to-GDP ratio from 15.6 percent in 2013 to an average of 17.2 percent during 2014–16. Ongoing reforms in the energy sector are expected to improve the financial position of ENEE. Enhanced public financial management, particularly in the areas of procurement and payroll, is expected to yield fiscal savings. Furthermore, ongoing efforts to improve the efficiency of social protection systems are expected to help cushion the impact of fiscal consolidation on the most vulnerable.

The magnitude of the consolidation has been significant, with the total fiscal adjustment reaching 3.3 percent of GDP between 2013 and 2014, before rising to a projected 5 percent by 2016. The reforms implemented thus far represent important steps in the right direction, but they will require substantial political will to sustain over the medium term. However, the consolidation effort has already enabled the government to cut its fiscal deficit, and the positive response of international lenders is evident in the improvement in yields and maturities for new domestic bonds, as well as the yields for international bond issues in 2013.

External imbalances are highly correlated with the fiscal deficit, and fiscal consolidation could alleviate the pressure on the external accounts. Expansionary fiscal policies have exacerbated the impact of exogenous shocks on the current account. Each additional US\$100 in public spending is associated with an increase in the current-account deficit of US\$14, *ceteris paribus*. Moreover, fiscal consolidation could help Honduras restore its credit rating, which was downgraded in 2013, and thereby reduce the cost of foreign financing.

The fiscal consolidation program is intended to stabilize the debt trajectory. Honduras' risk of public external debt distress is currently considered moderate. The debt-to-GDP ratio is expected to increase from 45.1 percent in 2013 to a peak of 50.8 percent in 2017 and then decrease gradually to 36.1 percent by 2034.² External public debt is expected

to increase from 28.1 percent of GDP in 2013 to 32.9 percent in 2016, while domestic debt is projected to remain at 17.7 percent of GDP through 2016. Interest payments are projected to increase from 2 percent of GDP in 2013 to 3 percent in 2016, in line with the rise in the public debt stock. Under a number of alternative scenarios public debt dynamics in Honduras will remain somewhat vulnerable to both policy-related and exogenous shocks, especially those involving lower economic growth and a worsening fiscal balance. The ratios of the present value of public debt and public debt service to GDP are expected to remain well below their indicative thresholds under the baseline scenario, and no alternative scenarios cause the debt-to-GDP ratio to breach its threshold.

Structural Risks

Serious structural challenges inhibit the government's efforts at fiscal consolidation, particularly the lack of an effective expenditure-control system. Weak budgetary controls have caused spending to repeatedly exceed projections, weakening the credibility of the budget. During budget preparation the line ministries set unrealistic targets, and the Ministry of Finance does not have a system in place to amend them. In addition, after the budget has been approved new expenditures are introduced on an ad hoc basis, and these supersede the ceilings set by the Ministry of Finance. Line ministries often demand that new projects be added to the budget at different points throughout the fiscal year, and these expenditure lines are introduced without a formal budget review or project evaluation process. Moreover, line ministries sign contracts for new projects before securing adequate financing, and these contracts often breach their respective budget ceilings. Recent legislation limits the ability of Congress to increase the budget without confirming the availability of funding.

Over the last five years falling domestic demand for new government bonds and limited access to official external financing have led to the accumulation of domestic arrears, the so-called "floating debt." As of December 2014, the stock of floating debt was estimated at 3 percent of GDP. The growth of the floating debt is mainly due to

weak budgetary controls and the poor financial performance of state-owned enterprises, particularly ENEE. The accumulation of arrears to government contractors appears to have exacerbated the recent economic slowdown.

The low institutional capacity of the national revenue authority is a major obstacle to public financial management. Political interference in the hiring process is a major liability, and the Ministry of Finance estimates that 70 percent of revenue authority staff do not possess the appropriate academic qualifications. Organizational deficiencies also affect revenue performance, including inadequate information systems that do not ensure transparent and effective tax collection. Moreover, income and sales tax collection remains low due to a regulatory gap that prevents the correct application of the tax code, as well as the presence of about 200 legal exceptions to the tax code. The prevalence of the informal sector also hinders tax collection.

While previous reform efforts have proved short-lived, and this record should temper expectations, the authorities have thus far demonstrated a credible commitment to fiscal consolidation and macroeconomic stability. The full impact of the government's current efforts will not become apparent immediately, and cuts to current spending may even slow growth in the short term. However, over the longer term the successful consolidation of the public finances will be essential to reinforcing resilience and accelerating economic growth.

5.3 Social Sustainability

Addressing challenges in crime, lack of youth inclusion and weaknesses in land rights would help build the country's social sustainability by fostering social cohesion and empowerment. Rising levels of crime and violence represent both a threat to macroeconomic growth and a major source of household-level vulnerability. Honduras' crime and violence rates are among the world's highest, and due to its location the country has become a transit route for drug

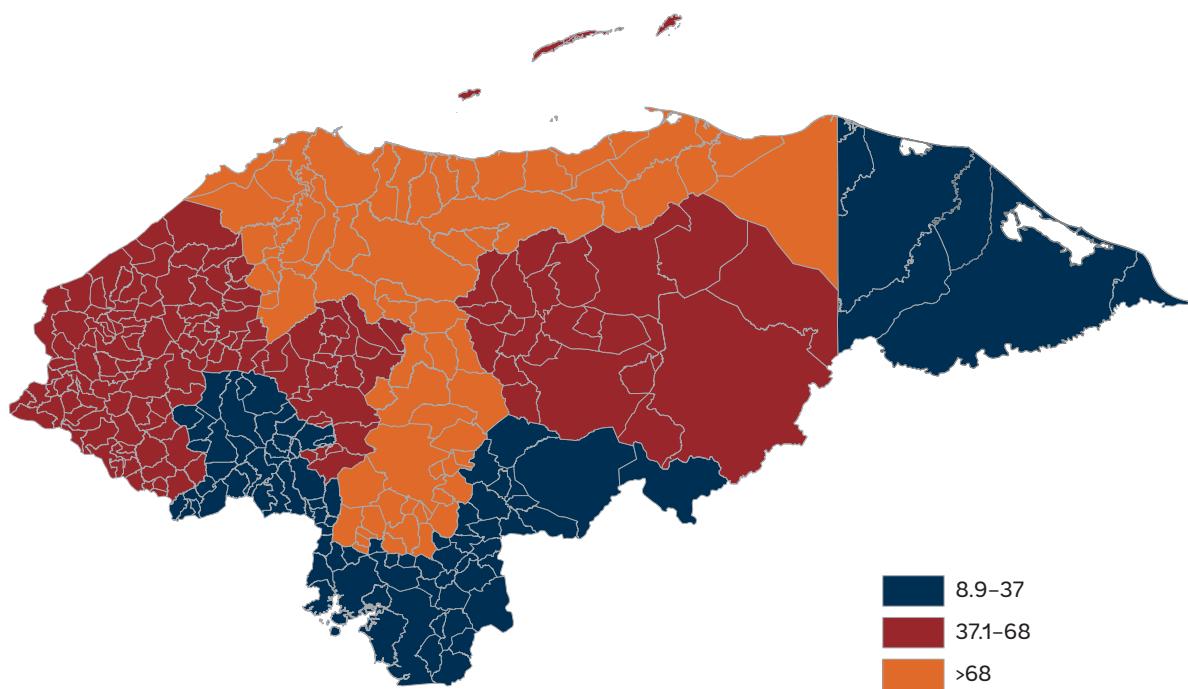
trafficking. Inadequate mechanisms for assigning and enforcing land tenure are a further source of social instability, and insecure property rights have exacerbated violence and economic exclusion. Indeed, most privately held land in rural Honduras is untitled or improperly titled, and the level of land inequality is high. The government has pursued legal and institutional reforms designed to strengthen land tenure but still lacks both a comprehensive policy and effective mechanisms for inter-institutional coordination.

Crime and Violence

Crime and violence are among the main challenges to social sustainability in Honduras today, as the entire country suffers from elevated rates of violence (map 5.1). Hondurans increasingly identify crime as one of the country's biggest problems (figure 5.1). Even though the data suggest a modest decline in 2013 and 2014, Honduras' homicide rates remain far above those of any other country in the world (figure 5.2). Gangs and drug trafficking drive high crime rates, and young men are the most likely to be both perpetrators and victims of violence. The cost of crime is estimated to represent 10 percent of GDP (US\$900 million) per year, with crime-related health costs alone amounting to an estimated 1.3 percent of GDP. A 10 percent reduction in crime would increase GDP by an estimated 0.7 percent (World Bank 2011a). Crime is a major obstacle to doing business, and its effects are believed to fall most heavily on the poor.

The majority of homicides in Honduras go unsolved, which has eroded citizens' confidence in the police and the rule of law. Few homicides are investigated and fewer still are prosecuted. It is estimated that 97 percent of murders in San Pedro Sula go unsolved. Trust in public institutions is low and has deteriorated over the past eight years (figure 5.3). In 2012, Honduran respondents registered the lowest level of police confidence in the region.³ In addition to demanding bribes, passing information to criminal groups and allowing drug shipments to pass unchecked, some elements of the Honduran police have reportedly

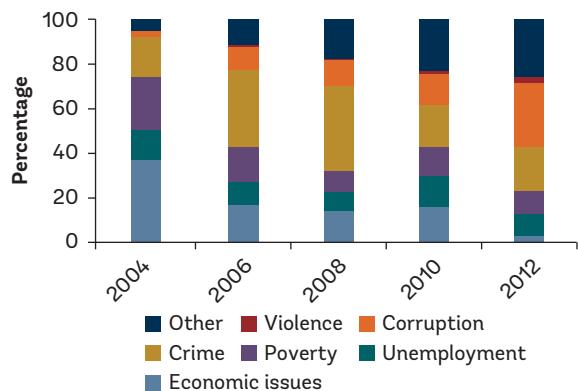
MAP 5.1 Though Homicide Rates Vary by Region, They Are High Throughout the Country
(Homicide rates per 100,000 inhabitants, by department, 2014)



Source: Dirección de Estadística Policía Nacional/Observatorio de Violencia, UNAH.

FIGURE 5.1 Surveys Increasingly Identify Crime and Corruption as Honduras' Main Problems

(Main problem in the country, percent age of respondents, 2004–12)



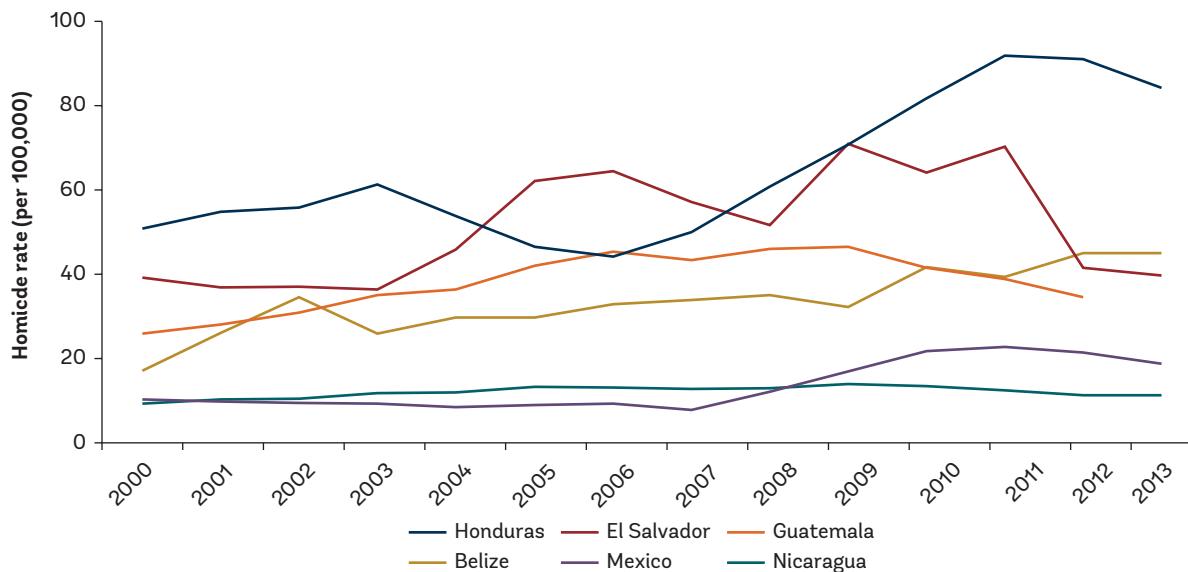
Source: Latin American Public Opinion Project (LAPOP).

participated in, and even directed, violent criminal operations. In recent years some reforms have been made to the country's law enforcement, including allowing the military to carry out police functions.

Due in part to its geographic location, Honduras has become a transit country for drug trafficking. In the 2000s Colombian drug cartels cemented Honduras' status as the principal trafficking corridor for cocaine bound for Mexico, further undermining the country's security (Arnson and Olson 2011). San Pedro Sula, the country's manufacturing capital, has become a hub for cocaine trafficking, and its homicide rates have been the highest in the world for four consecutive years.⁴ Moreover, arms trafficking has taken a heavy toll, and 83 percent of homicides in San Pedro Sula are committed with firearms. Most of the 18,000 Honduran children who have fled to the U.S. in recent years were originally from San Pedro Sula.⁵

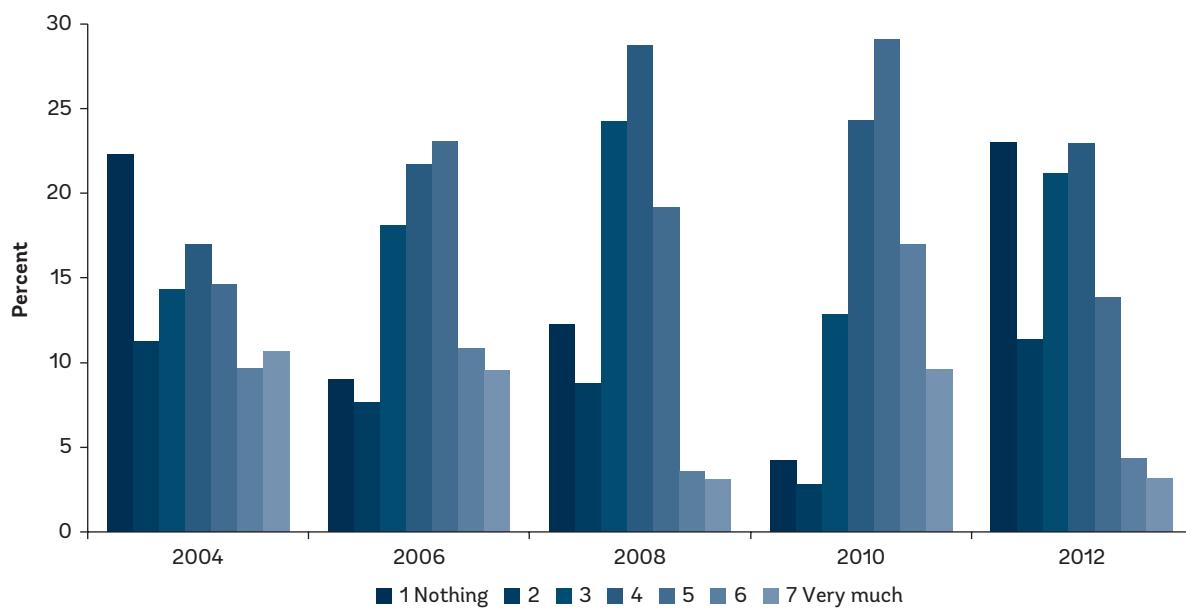
Youth violence and gangs (or *maras*) are a critical concern in Honduras. Estimates of the overall number of gang members in the country vary widely. In 2007, the U.N. Office on Drugs and Crime (UNODC) estimated 36,000 gang members in Honduras whereas a 2012 report

FIGURE 5.2 Homicide Rates in Honduras Have Grown Dramatically since 2000
(Homicide rates per 100,000 inhabitants, by country)



Source: UNODC Statistics.

FIGURE 5.3 Confidence in the Government Is Low and Declining Over Time
(To what extent do you have confidence in the national government?)



Source: Latin American Public Opinion Project (LAPOP).

claimed there were only 12,000 (United Nations Office on Drugs and Crime 2007, 2012; World Bank 2011a). Nonetheless, gangs have become a pressing issue in the country. They control entire neighborhoods and generate income primarily

through extortion, drug trafficking and kidnapping. Although the major gangs are most active in the capital, Tegucigalpa, they are present throughout the country. Policies aimed at reasserting public security through anti-gang

KNOWLEDGE GAP How Does Crime Affect the Welfare of the Bottom 40 Percent in Honduras?

There is limited information on how crime affects the welfare of lower-income households in Honduras. Data collection in this area is challenging not only because of the high levels of violence in poorer neighborhoods, but also because of the reluctance of respondents to speak openly about crime. Efforts to improve data collection and analysis will be necessary to develop evidence-based policies in this areas.

TABLE 5.2 Homicide Rates per 100,000 Inhabitants, by Age and Gender, 2014

Age group	Female	Male
0-4	3.2	2.2
5-9	0.8	1.5
10-14	4.0	8.9
15-19	16.7	130.4
20-24	19.9	268.9
25-29	16.6	270.9
30-34	16.3	240.6
35-39	19.2	203.3
40-44	20.2	179.7
45-49	19.1	158.7
50-54	12.4	130.1
55-59	13.3	143.2
60-64	9.8	123.9
65+	7.4	62.2
Total	11.9	125.6

Source: Observatorio de la Violencia, UNAH- IUDPAS. Edition 36 (2015).

crackdowns and large-scale incarceration largely failed because they did not address the root causes of gang membership or provide rehabilitation for gang members. Macro-social factors, such as a lack of education and job opportunities for at-risk youth and rising levels of poverty and unemployment, have perpetuated the gang problem (World Bank 2011a).

The country's high crime and violence rates expose young people to risks and present serious obstacles to education and employment. Men between the ages of 20 and 34 face a staggering homicide rate of 240 per 100,000 (table 5.2). Adolescents between the ages of 15 and 19 also face elevated homicide rates, particularly boys. While the majority of homicide victims are men, between 2005 and 2013 violent deaths among women increased by 263 percent.⁶ Differences in

the age distribution of men and women suggest some differences in causes of homicide as women between the ages of 20 and 50 had approximately the same homicide rate even as rates peaked for younger men, possibly due to the latter group's higher involvement in drug trafficking and gangs.

Domestic violence and violence targeted at the lesbian, gay, bisexual, and transgender (LGBT) population is also a serious concern. More than a quarter of Honduran women over age 15 (27 percent) report being victims of physical violence.⁷ Spouses and partners were the main perpetrators of violence (35 percent), followed by ex-spouses or ex-partners (24 percent). Urban women and those with less schooling were more likely to report being victims of domestic violence. 26 murders of LGBT people were reported in 2013, including 11 transgender women, 11 gay men, and 4 lesbians (Catrachas 2013). Violence against transgender victims was more likely to take place in public places and involve excessive force. Gender identities and norms shape both male and female attitudes towards gender-based violence; as a result, 16 percent of Honduran women believe that wife-beating is justified under certain circumstances.⁸

Excluded Youth

Honduras has the largest share of young people who neither attend school nor are employed in the region, and members of this group are particularly vulnerable to crime, both as perpetrators and victims. Approximately one in four Hondurans between ages of 15 and 24 are neither employed nor enrolled in school. These young people are described as “ni estudian ni trabajan”

(neither studying nor working), and are sometimes referred to as “*ninis*.” Nearly 40 percent of girls aged 15–24 and 11 percent of boys in the same age group are part of this group. High rates of male youth who are neither employed nor in school in a context of violence and organized crime is associated with an increase in the homicide rate (De Hoyos, Gutierrez, and Vargas 2015; De Hoyos and Székely 2015 forthcoming). Moreover, there is a larger share of unattached youth in rural areas and across the poorest income quintiles. Roughly a quarter of urban youth are neither in school nor employed, whereas this share rises to nearly a third in rural areas. In addition, more than a third of youth in the poorest income quintile are not employed and out of school, compared to just 14 percent in the highest quintile (figure 5.4). Low rates of youth employment and lower educational attainment reduce the long-term productivity of the labor force.

Marriage and pregnancy are the most important factors that cause young women to drop out of school and exit the labor force. In 2013, 44 percent of young women between the ages of 15 and 24 years old who were not working, including nearly a quarter of those under 18, were already married. Teenage pregnancy remains a critical concern, as

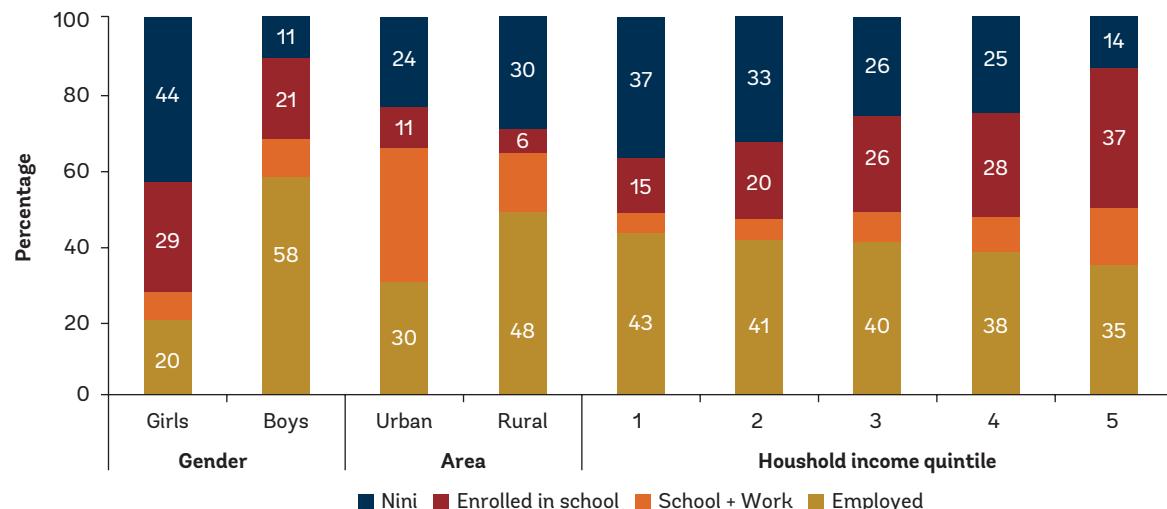
nearly a third of all births in Honduras are to mothers under 19 years old. While the pregnancy rate in Honduras fell from 104.9 births per 1,000 teenage women in 2001 to 84 in 2012, it remains well above the LAC average of 68.6. Honduras’ teenage pregnancy rate is the second highest in the LAC region (Azevedo et al. 2012). Access to contraception has increased over the past decade, but teenagers have the lowest rate of contraceptive use at 56 percent and 71 percent for married and unmarried women, respectively.

In Latin America, the incidence of young people who are neither in school nor employed is typically higher among poorer households. Even though this pattern is evident among young women in Honduras, there is no clear correlation among young men (figure 5.5). The highest rate among young men in Honduras is found in the fourth quintile (13.9 percent), followed by the second (12.7 percent) and third quintile (11.4 percent). This suggests that the prevalence of young men in Honduras who are neither employed nor in school may be more closely linked to a lack of educational opportunities or an absence of applicable labor skills.

Developing a strategy to reduce school drop-out rates, provide workforce training

FIGURE 5.4 Young People Who Neither Attend School Nor Are Employed Are from Poorer Households

(Non-working, non-student youth by gender and income quintile, 2013)

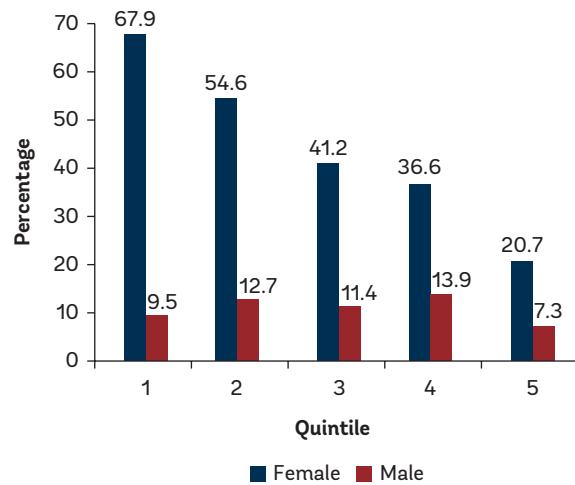


Source: World Bank estimates based on EPHPM.

opportunities and rehabilitate young people who have been involved with gangs should be regarded as a key priority. Nearly half of Honduran youth drop out of the education system by age 15 (figure 5.6). This suggests that interventions to promote continued enrollment should focus on

basic secondary education. Providing training, job opportunities and outreach efforts to youth, including those who have been involved in gangs and drug-trafficking, would help to break the cycle of poverty and violence in Honduras.

FIGURE 5.5 Poorer Young Women Are More Likely to Be Out of School and Not Working (Unemployed, out-of-school youth by gender and income quintile, ages 15–24, 2013)

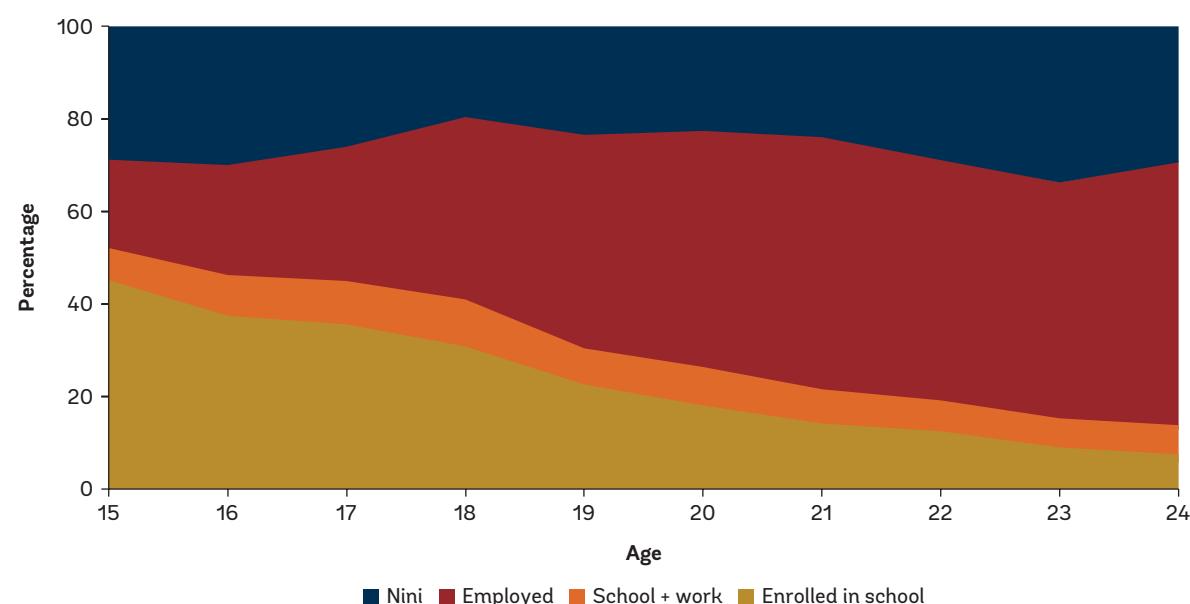


Source: World Bank estimates based on EPHPM.

Land Tenure

Issues related to land tenure pose a challenge to social sustainability, as violence has erupted over contested property rights, and they have important negative implications for economic and environmental sustainability. As noted in chapter 3, approximately 80 percent of privately held land in rural areas and 30 percent of urban land is not properly titled. During the last decade the government has pursued numerous legal and institutional reforms aimed at strengthening rights to real property, including the Territorial Ordering Law of 2003, the Property Law of 2004 and the Forestry Law of 2007. Yet despite an improving legal and institutional framework land tenure remains a major issue in Honduras. Land disputes represent between 10 and 30 percent of all cases in the judicial system. It is estimated that 70–90 percent of these cases are resolved in the first

FIGURE 5.6 Half of Honduran Youth Are Out of the Education System by Age 15 (The transition between school and work in Honduras, 2013)



Source: World Bank estimates based on EPHPM.

instance,² and delays are due to case backlogs, a lack of documentary evidence and witnesses, and the absence of a specialized tribunal for land cases. A socially inclusive and environmentally sound agenda for strengthening property rights among the rural and urban poor should include supporting women's access to land, formalizing the recognition of communal lands held by indigenous communities, and promoting the sustainable use of water and forest resources.

Honduras has high levels of land inequality in rural areas. Only 9.5 percent of the country's total land area is arable, of which approximately

28 percent is dedicated to seasonal agriculture and 3 percent to permanent crops, 39 percent is forest, and 20 percent is dedicated to national parks and protected areas. Large and small farmers compete over the country's limited arable land. The poorest 70 percent of farmers own 10 percent of the land as smallholdings, while the richest 1 percent of farmers own 25 percent of the land as large plantations (USAID 2011). The growth of industry and tourism is intensifying competition for farmland, at times leading to social conflict (box 5.2).

Land reform programs have been unable to solve the problem of land inequality. Between

BOX 5.2 Improving Environmental and Social Safeguard: Corporación Dinant Case

In 2009, International Finance Corporation (IFC) provided a loan to Corporacion Dinant a large vertically integrated Crude Palm Oil, snacks and food producer based in Honduras. IFC's investment in Dinant was subsequently audited by the compliance advisor ombudsman (CAO) in 2013 following complaints from Human Rights NGOs referring to Dinant's security forces involved in confrontation with armed farmer groups. Both campesinos and Dinant security guards died in the course of campesino land incursions on Dinant palm plantations. The CAO identified shortcomings in the environmental and social due diligence carried out by IFC at the time of its investment and during supervision.

Improvements and Remedial Actions: At the institutional level IFC has taken a number of steps to strengthen its Performance Standards (particularly with respect to agricultural supply chains) in response to lessons learned from cases such as Dinant. At the micro level, and prepared in consultation with stakeholders, an Enhanced Action Plan (EAP) articulates IFC's response to the CAO audit and is currently under implementation. The EAP seeks to address both Dinant-specific environmental and social improvements as well as some of the critical and more systemic social, security and environmental issues that are manifested in the agrarian conflicts around land in the Aguán Valley. In parallel, IFC with the support of consultants experienced in conflict resolution and the Voluntary Principles on Human Rights (Consensus Building Institute and Foley Hoag), are carrying out a stakeholder Engagement and Dispute Resolution process and monitoring Dinant's security plan to ensure consistency with the Voluntary Principles for Security and Human Rights (VPSHR) and also advising on investigative protocols for past allegations regarding Dinant's security personnel.

To date, there has been significant progress in implementing the EAP. At the company level and as per IFC requirements, Dinant has undertaken a social baseline study for all project sites to better inform engagement with communities, is implementing a grievance management mechanism, and has hired new community liaison officers. The company has updated its security procedures following the VPSHR (reviewed by security consultant and Foley Hoag); hired a new Security Manager and currently in process of hiring a new private security contractor and now vets all new security personnel against defined protocols as per VPSHR. The company has carried out a security forum with communities in order to produce Community Risk Assessment for some locations and is the first company in Honduras to disarm its security guards to reduce the likelihood of armed conflict.

box continues next page

BOX 5.2 continued

Under the stakeholder dialogue process led by Consensus Building Institute, campesino organizations, local communities, Dinant and the GoH are deeply engaged in a process which seeks to address systemic issues relating to impunity, land and the future economic development of the Aguán. The Government of Honduras has expressed support for this initiative and has indicated at the highest levels that it is committed to find sustainable solutions to address the structural issues related to the Bajo Aguán conflict by: a) promoting dialogue with key stakeholders; b) strengthening capacity and capacity of the investigative bodies looking into human rights crimes; c) clarifying and reviewing historical patterns of land titling in the Bajo Aguán; and d) designing socio-economic development programs for the Bajo Aguán region. The Government is interested in using the synergies in the World Bank's portfolio (land, safer municipalities and agricultural projects) to provide support in the Bajo Aguán region.

1973 and 1977 the government legitimized informal land holdings and transferred land ownership to peasant farm cooperatives and associations. These reforms distributed 120,000 hectares of land to 35,000 poor families, representing 9 percent of rural households (Merrill 1995). However, the Agricultural Modernization Law in 1992 permitted members of cooperatives to individualize and sell their holdings. Some smallholders sold their land to large-scale agricultural producers, which resulted in the re-concentration of previously distributed land.

Indigenous and Afro-Honduran peoples are particularly vulnerable to land tenure insecurity. In 1995 the government signed Convention 169 of the International Labor Organization, asserting its commitment to recognize the land rights of indigenous peoples. Formalizing collective tenure of traditional lands is more complex and costly than single-owner parcel registration. The process requires that the group have a legally recognized leadership capable of holding land title. It is estimated that only 10 percent of the land belonging to indigenous and ethnic groups is formally demarcated and titled, which encourages encroachment and expropriation attempts by non-indigenous farmers, powerful business interests and government elites. One of the most significant achievements in this areas is the demarcation

and titling of nine territorial councils representing the Miskito people in the department of Gracias a Dios. Honduran law allows for the individualization of communal property, but this procedure has not yet been implemented and remains controversial among some indigenous organizations and NGOs.

The government has implemented a number of legal and institutional reforms designed to strengthen land tenure. The approval of the Property Law in 2004 allowed for the establishment of a new parcel-based registration system known as *folio real* to replace the existing owner-based system. Parcel-based registration improved the management of land records and facilitated the automation of land transactions. The law also created the Property Institute and established the National Property System, which includes a unified registry of cadastral information, regulations, and geo-spatial data. Since 2004 the World Bank-financed Land Administration Program (PATH) has assisted in the implementation of these reforms. The program is currently in its second phase and has invested in legal and institutional strengthening, cadastral surveying and titling. The automation of registration procedures has reduced the transaction cost from 8.7 percent to 5.7 percent of a property's value and cut the average number of days required to register a property from

35 to 22 according to the *Doing Business* report. The land registries modernized by the Land Administration Program register transactions in fewer than 15 days.

However, the government still lacks both a comprehensive land policy and an effective mechanisms for inter-institutional coordination. The national development strategy includes indicators on territorial planning and formal land tenure but does not establish an overarching land policy. Instead, each agency and jurisdiction has its own set of policies. Some municipalities are reported to have up to 200 territorial plans, and government agencies and donors develop plans independently of one another. Land administration functions are determined according to type of land tenure, which results in a complex legal framework overseen by multiple agencies. This creates overlapping competencies and inhibits effective enforcement. In addition, some sections of older sectoral policies remain applicable, further complicating land administration. For example, the titling of public land for coffee growing is still allowed despite prohibitions on issuing private titles in protected areas. There are a few examples of satisfactory inter-institutional coordination when the instrument requires co-management, yet it is still unclear what impact these plans have had on improving land tenure in Honduras.

5.4 Environmental Sustainability

Honduras is among the countries most affected by extreme weather events in the world. Honduras is susceptible to periodic disasters such as hurricanes and tropical storms, as well as cyclical droughts that may be exacerbated by human activity. Moreover, rapid urbanization, extensive land degradation and deforestation, air pollution, and inadequate water and sanitation represent major challenges to Honduras' development. Investment in physical and institutional infrastructure and continued efforts to strengthen

disaster-risk management are critical for enhancing resilience to climate change and natural hazards. In order to mitigate its inherent vulnerability, Honduras must improve the management of meteorological and geological knowledge, further developing risk-assessment mechanisms at the sector level and strengthen local and sectoral planning processes.

Vulnerability to Natural Hazards

Honduras' vulnerability to extreme weather events has been a major challenge to its development (Kreft et al. 2014). Honduras consists of three main geographic regions with distinct weather patterns: the extensive interior highlands, the Caribbean lowlands on the north coast, and the Pacific lowlands in the south. Droughts and irregular rainfall are common in the western, central, southern and southeast regions (the *Corredor Seco*). Tropical storms and cyclones can cause floods and landslides throughout the country, but are primarily concentrated in the northeast and along the Caribbean coast. Between 1994 and 2013 Honduras suffered the highest average annual economic losses due to weather-related disasters in Central America, driven mostly by Hurricane Mitch (Kreft et al. 2014). Although it has not suffered frequent earthquakes, Honduras is not exempt to seismic hazards.¹⁰ Adverse natural shocks combined with high vulnerability can cause serious long-term damage to human, social and physical capital, especially for the poor.

Cyclical droughts also have an impact on the country's development prospects. Dry periods associated with the *El Niño* southern oscillation phenomenon affect the western and southern areas of the country, which includes the *Corredor Seco* and is home to a large share of Honduras' extreme poor. Considerable crop losses following periods of drought increase the prices of stapled foods and lead to acute food insecurity. In 2014, the government declared a state of emergency following a severe drought that affected one million people

in 165 municipalities throughout the country. It was considered the worst drought to affect Honduras in 10 years.¹¹

The *Corredor Seco* makes up more than half of Honduras' territory and includes many of the poorest municipalities in the country, with nearly 91.7 percent of the population (650,000 inhabitants) living below the extreme poverty line.¹² The *Corredor Seco* experiences irregular precipitation levels and a longer dry season, which is intensified during *El Niño* periods when rainfall is reduced by between 30 and 40 percent.¹³ Small-scale subsistence farmers and small rural communities are the most vulnerable to droughts, which reduce access to fresh water sources and negatively affect the livelihoods of the rural population. Soil degradation is a major cause of agricultural vulnerability due to its negative effects on water infiltration and retention capacity, fertility, crop yields, and general resilience to droughts. Diversification, innovation, and the widespread adoption of climate-smart agriculture in efforts to secure the triple win of higher agricultural productivity, increased resilience to climate change, and lower greenhouse gas emissions are essential steps for building resilience of small agricultural producers.

Urbanization

Rapid urbanization, high rates of overall population growth and the growing concentration of settlements and assets in hazard-prone areas—compounded by considerable environmental degradation—have intensified Honduras' vulnerability to natural hazards. The country's urban population growth rate is higher than the national population growth rate at 3.16 and 2.01 percent, respectively. UN-Habitat projects that by 2025 more than 60 percent of the Honduran population will live in urban areas. The rapid growth of urban areas has resulted in a sprawling and unorganized pattern of residential development. Over a third of urban dwellers live in slums and are not connected to regular services such as waste collection and drainage. The limited provision of public services such as electricity and

water and the lack of appropriate drainage systems heighten the risk of floods in urban areas. In addition, deforestation and poor construction practices have led to the proliferation of settlements on increasingly steep slopes or along riverbanks, increasing the risk posed by landslides (Gencer 2013).

Logging and Land Degradation

Extensive land degradation and deforestation from logging and the clearing of land for agriculture and cattle ranching represent major environmental challenges. The decline of forest cover affects the *Corredor Seco* and small agricultural producers, and 2 percent of the country's land was deforested between 2005 and 2010 alone (FAO 2012). The deforestation rate of over 2 percent per year in Honduras exceeds the global average. It is nearly twice the average for Central America and one of the highest in Latin America. It is estimated that by 1987 about 750,000 hectares of Honduran land was already seriously eroded as a result of cattle ranching on unsuitable areas and slash-and-burn agriculture (GFDRR 2010). From 2000 to 2013, the country's total forest area decreased by 4.4 percent, or approximately 486,000 hectares (Hansen et al. 2013). Deforestation negatively affects poor rural households given their dependence on forest resources, including food, fodder and fuels, as one of their main sources of income. Moreover it damages critical ecosystem services such as soil fertility and watershed protection, with negative implications for poor households (SIDA 2006).

Exacerbated by poverty, households rely heavily on firewood, threatening forests and imposing health risks due to indoor air pollution. As of 2013, four out of five households in the bottom 40 use firewood as their primary cooking fuel. Burning solid fuels produces high levels of indoor air pollution, and indoor firewood smoke can have negative health consequences, particularly for children and women. Women exposed to indoor smoke are three times more likely than women who cook with

electricity, gas or other cleaner fuels to suffer from chronic obstructive pulmonary disease, such as chronic bronchitis or emphysema (WHO 2006). In 2010, damage associated with air pollution represented 5.6 percent of GDP. Driven by indoor air pollution, this represents a 50 percent increase in cost from 2005.

A substantial portion of Honduras' forests are protected areas, but limited state management capacity and high levels of corruption facilitate illegal logging (Ribot and Larson 2007). Extensive cattle ranching and slash-and-burn agriculture, closely associated with logging for timber, is a driving cause of deforestation and the resulting vulnerability to natural hazards. A deeper understanding of the factors underlying the rapid change in land use is needed, including the role of local institutions and forest tenure rights in providing the incentives for sustainable land use and conservation of natural resources.

Water Security and Sanitation

A number of major river basins and lakes throughout the country are strained by rising population levels and agricultural, industrial and mining run-off. Pollution from untreated waste degrades the quality of water resources. In Honduras approximately 99 million cubic meters of wastewater are discharged per year into water bodies without any type of treatment.¹⁴ Moreover, 2.2 million people do not have access to improved sanitation services, half a million of which still practice open defecation. This, coupled with unregulated fecal sludge management,¹⁵ further degrades aquifers and surface water quality, with adverse impacts on health and economic growth. In Tegucigalpa alone deficient water infrastructure and poor sanitation services cost over US\$135 million per year.¹⁶

Climate variability accentuates drought cycles and impacts the water supply, particularly in rural areas. Honduras has over 7,000 registered rural water systems administered by local inhabitants, the majority of which face challenges in post-construction support. As a result of annual droughts about 28 percent of rural water systems

run dry at least once during the dry season, and over half of existing rural water systems lack functioning water treatment systems. Storage facilities could mitigate the effects of seasonality, but few have been built. Although an effective rural water and sanitation information system is in place, there is inadequate capacity at the central and local levels to provide up-to-date and consistent information to guide the planning process and facilitate interventions.

Investments in water and sanitation have failed to keep pace with urban population growth. Current annual investments represent just 0.13 percent of GDP, with an estimated shortfall of US\$350 million between current spending levels and the amounts needed to meet national targets (World Bank 2013b). With approximately 93 billion cubic meters per year of fresh surface water and an annual water-availability average of nearly 11,381 cubic meters per capita the country is well above water stress levels. However, Honduras uses less than 9.1 percent of its available water resources. In Tegucigalpa just 83 percent of the population has access to water, 70 percent has access to sanitation, 80 percent has access to solid waste management, and only 17 percent has access to wastewater management. While the share of the population with access to water services is higher than in the rest of the country, water resources in the capital do not meet demand, and the deficit is estimated at 60 million cubic meters per year. Shortages are most common in the dry season, which accounts for 50 percent of total demand. As a result, water restrictions are imposed during most summers, which disrupts the water supply and increases the likelihood of waterborne disease outbreaks. The economic cost associated with a lack of reliable water service and waste management in Tegucigalpa is estimated at US\$160 million per year, or 2.5 percent of Honduras' GDP (World Bank 2012a).

The process of decentralizing water and sanitation services is still underway, and limited progress in this area undermines water security and service quality in major cities. Under the current laws municipalities are responsible

KNOWLEDGE GAP What Is the Relationship between Vulnerability, Extreme Weather Events and Poverty?

Heightened vulnerability to extreme weather events coupled with the challenges of a growing urban population compound the structural inequalities that create and sustain poverty and constrain access to resources. Nevertheless, this relationship needs to be better understood in order to develop a comprehensive vulnerability assessment for Honduras that takes into account the linkages between natural hazards and poverty, as well as measures to improve the coping and adaptive capacities of the poor. Improving the availability, coverage and quality of data is crucial to develop qualitative and quantitative approaches to assess the determinants of poverty, measure the effects of disasters, and identify vulnerabilities at the household, sector and national levels. Time-series data on risk conditions, disaster impact assessments, household income and expenditure evaluation, a poverty index and an analysis of the geographic distribution and socioeconomic characteristics of the poor are just some of the potential areas for further research.

for providing water services; however, only 60 percent of the population is currently supplied by a decentralized service provider. The National Service of Aqueducts and Sewage Systems still operates in 13 urban centers and provides limited services to over 1.5 million people, including 71,000 poor families in the capital's peri-urban areas. Many water systems are located in areas highly vulnerable to climate change. The local government in Tegucigalpa is in discussions with the central government to take over the capital's water and sanitation system.

Priority Policy Areas for Enhancing Environmental Sustainability

In recent years the government has made key political, legislative and institutional advances toward developing an integrated and proactive approach to disaster-risk management. This includes adopting guiding policies to reduce the country's vulnerability to the impacts of climate variability and climate change, as well as a gradual shift toward a culture of disaster-risk prevention. Key achievements include (a) the incorporation of risk-reduction and mitigation considerations in the 2010–38 Vision for the Country (*Visión de País*) and the corresponding 2010–22 National Development Plan (*Plan de Nación*); (b) the formulation of a 2010–38 National

Climate Change Strategy to prioritize programs and activities; (c) efforts to formalize and coordinate inter-institutional disaster response and risk-management capacity at the national level, as reflected in the consolidated legal framework established through the National System for Risk Management in 2009; (d) the strengthening of technical and institutional capacities for disaster-risk management and adaptation to climate change in key agencies; and (e) efforts to promote the active participation of municipalities in conducting risk analyses and preparing planning instruments.

Despite recent progress in improving the framework for disaster risk management and climate adaptation, Honduras should invest more heavily in efforts to enhance resilience to climate change and natural hazards. Honduras ranks 128 out of 178 countries in terms of climate change vulnerability and its readiness to improve resilience.¹⁷ Among the most vulnerable countries, Honduras ranks as the 30th least prepared to improve resilience. Furthering efforts to move from a reactive to preventive response will be key to lower the social and economic costs associated with natural hazards and improve the environment for growth, inclusion and sustainability. Box 5.3 identifies specific steps that Honduras should take to improve its resilience to disasters and climate change.

BOX 5.3 Measures to Improve Resilience and Disaster Risk Management

- Develop an effective budget management strategy that allows for the rapid mobilization of resources in the event of a natural disaster while still protecting fiscal accounts. When a disaster strikes, Honduras will have to mobilize resources quickly without jeopardizing its fiscal stability. A financial protection strategy that combines a number of instruments in a risk-layering approach could help the country meet its financial needs and manage fiscal volatility. The strategy should incorporate: (a) budget allocations and reserves, (b) contingent credit, and (c) risk-transfer instruments.
- Improve the management of meteorological and geological knowledge, early warning systems and climate data to support informed decision making. Effective risk reduction and climate change adaptation policies should be based on reliable data. Improving monitoring, forecasting and early warning systems, and generating the required evidence base for climate variability and climate change would be important steps in this regard. The monitoring and modeling capacity of geological hazards should also be strengthened. This will require bolstering existing observation networks, as well as reinforcing the financial sustainability of the recently established National Center for Atmospheric, Oceanographic and Seismic Studies and improving other coordination mechanisms focusing on climate and geological information.
- Assess and reduce the structural vulnerability of public assets. Focusing on the structural dimensions of resilience by conducting risk assessments of public infrastructure, including schools and other public buildings, would identify vulnerabilities and improve risk mitigation. At the same time, the capacity to understand infrastructure vulnerability and effectively incorporate this information into decision making at the local level must also be enhanced.
- Strengthen territorial and sectoral planning processes to better integrate risk-reduction criteria and land-use planning. Effectively managing disaster risk and reducing vulnerability will require substantial efforts to build strategic planning capacity at the local and sectoral levels. The integration of risk-management strategies into planning tools would help reduce vulnerabilities associated with inefficient land use, poor water management and inappropriate building practices. This should be complemented by efforts to better incorporate disaster-risk management and climate change adaptation criteria into the public investment process.

Notes

1. More than 90 percent of the budget for education is used to pay salaries, while investment in the sector has never surpassed 1.5 percent of GDP.
2. IMF 2014 Stand-by Arrangement.
3. LAPOP 2012.
4. Seguridad, Justicia y Paz <http://www.seguridadjusticiaypaz.org.mx>.
5. Based on data from the Department of Homeland Security as reported in <http://www.pewresearch.org/fact-tank/2014/07/01/dhs-violence-poverty-is-driving-children-to-flee-central-america-to-u-s/>.
6. IUDPAS, *Observatorio de Muertes Violentas de Mujeres y Femicidios*, January–December 2012.
7. World Bank tabulations based on data from the ENDESA 2011–12 survey.
8. World Bank tabulations based on data from the Reproductive Health Survey.
9. Land Governance Assessment Framework. Property Institute.
10. Honduras has been mostly unaffected by the frequent earthquakes. However, the country suffered a magnitude 7.1 earthquake on May 28, 2009, killing 7 people and causing estimated losses of US\$100 million (EM-DAT 2013). Probabilistic risk models estimate losses associated with an event of a 500 year return period at approximately US\$2.2 billion, representing 6.3 percent of GDP and an average annual loss equivalent to US\$35.5 million (0.103 percent of GDP of 2013) (CCRIF SPC, 2014).
11. COPECO, 2015.
12. Government of Honduras' Proposal to the Global Agricultural and Food Security Program. May 2013. Calculations from the Technical Food and Nutrition Unit of the Presidency (UTSAN), 2011.

13. SERNA, FAO 2014.
14. FOCARD-APS-Regional Diagnostic on Waste Water and Excreta Management in Central America and Dominican Republic (2013).
15. LationSAN 2013 Central America Sub-Region report, Chart 4.
16. Integrated Urban Water Management, Blue Water Green Cities Initiative, p. 24, available online at <http://siteresources.worldbank.org/INTLAC/Resources/2578031351801841279/1PrincipalIntegratedUrbanWaterManagementENG.pdf>.
17. Global Adaptation Index, ND-GAIN.

Chapter 6

Taking Stock and Priorities Ahead

6.1 Challenges Facing Poverty Reduction

Honduras is one of the poorest countries in the Western Hemisphere. Honduras' poverty rate stood at almost 65 percent in 2013, and the extreme poverty rate was close to 43 percent. With almost one in five people living on less than US\$1.90 per day, Honduras is the second-poorest country in Latin America. Nearly 80 percent of Honduras' youth (population under 15 years old) live in poverty, and approximately one in four children in Honduras is undernourished, with negative implications for their future learning abilities and earnings capacity.

Honduras' high poverty rates result from both low per capita growth and high inequality, which are perpetuated by macroeconomic volatility and high exposure to natural hazards. These negative dynamics will continue to deepen and perpetuate intergenerational poverty, unless ambitious, well-designed policies, and targeted interventions can break the mutually-reinforcing cycles that have kept Honduras locked in a low-growth equilibrium for decades. Understanding key characteristics of Honduras and its social and economic dynamics helps to inform the discussion about such policies.

- First, poverty in Honduras is not only high but also persistent. Despite data limitations both quantitative and qualitative indicators reveal the modest progress in poverty reduction achieved over the past several decades. In 1960 Honduras' per capita income (in current US\$ terms) was 5.6 percent of the US per capita income and 13.5 percent of the average per capita income for the World Bank's High-Income Countries group. In 2014 these same indicators were 6.2 percent and 4.3 percent, respectively. In other words, in 1960 Honduras

was already well behind standard comparators, and its per capita income has diverged from that of wealthy countries over the last 55 years.

- Second, two challenges have emerged over the past 15 years: crime and emigration. These challenges have created self-reinforcing cycles that contribute to an equilibrium of low growth, high crime rates and large emigration flows. High crime rates—Honduras generally leads the world in homicides per capita, with 67 homicides per 100,000 inhabitants in 2014—negatively affect the investment climate and hinder growth. In turn, low growth limits the ability of the economy to generate economic opportunities for the population, encouraging criminality. Low growth also incentivizes emigration and remittances. While remittances have had a positive impact on poverty, the analysis also suggests that they affect the labor supply (i.e., through higher reservation wages) and drive real exchange rate appreciation, reducing competitiveness and slowing growth. Both high crime rates and large emigration flows are relatively recent challenges. According to data collected for the 2011 World Development Report Honduras' homicide rate in the early 1990s was below 20 per 100,000 inhabitants, similar to the level in other Central American countries. However, the late-1990s and early-2000s witnessed a dramatic increase in crime. Similarly, remittances flows in 1997, just before Hurricane Mitch, represented about 4 percent of gross domestic product (GDP), but have since risen to 17 percent. Neglecting the long-term structural forces that have slowed growth in Honduras since the mid-20th century would result in a partial and incomplete picture of the country's development challenges.

- Third, because high poverty has persisted for many decades, it is necessary to look beyond the challenges of crime and emigration, and understand the long-stranding drivers of low growth and high income inequality. Unlike in some countries where poverty is the result of either low growth or high inequality, in Honduras both elements are present. Over the 1960–2014 period, Honduras’ per capita GDP growth rate was just 1.2 percent, about half the rate of the High-Income Countries group (2.3 percent) and well below the average rate for the Low- and Middle-Income Countries group (3.1 percent). Similarly, with a Gini coefficient of 0.54 in 2013, Honduras has the second highest rate of inequality of Latin America, which is itself one of the most unequal regions in the world, and while the regional middle class expanded over the past decade, Honduras’ middle class remains small. Honduras’ Gini coefficient in the early 1990s (0.56) was already among the highest in the Latin America after Brazil (0.59) and similar to that of Colombia (0.56). Comparisons for earlier periods are complicated by data limitations, but estimates suggest that inequality in Honduras has deep roots. In 1925, Honduras’ literacy rate was 29 percent, compared to 36 percent in Mexico, 40 percent in Colombia and 64 percent in Costa Rica. Only Guatemala had a lower literacy rate at 15 percent.
- Fourth, tackling Honduras’ high poverty is further complicated in a context of macroeconomic volatility. During 1960–2014 the standard deviation of growth in Honduras from the Low- and Middle-Income Countries group, the US, and the High-Income Country’s group was 44, 52, and 83 percent, respectively. Macroeconomic volatility has a profound impact on poverty because the poor tend to have limited means to absorb negative shocks, and because such shocks often have lasting effects on both growth and equality. Indeed, there is a wealth of empirical evidence that income volatility both contributes to lower economy-wide growth and encourages coping behaviors among poor

households that may reduce their chances of escaping poverty.

Low Growth

Breaking Honduras’ complex low growth/high poverty equilibrium will require addressing structural challenges. The analysis of the barriers to growth in Honduras has noted several long standing chronic constraints that have undermined the development of a dynamic formal sector in the economy, and by extension, the creation of high-quality jobs:

- Lack of fiscal discipline in the past has led to accumulation of debt that has undermined public social spending and investment, and reduced the effectiveness of private investments.
- A shortage of skills and limited access to school for much of the population—despite the fact that Honduras has one of the highest education budgets in LAC as a share of GDP—hinders productivity, growth and innovation, and contributes to a growing productivity gap between Honduras and its peers.
- Inadequate infrastructure lead to high costs of transportation, electricity, and telecommunications, reducing the country’s international competitiveness.
- Relatively low access to capital (finance and land), particularly for SMEs and rural activities, undermine the potential for profitable business opportunities and job creation.
- A regulatory framework affecting both the labor market (e.g., high minimum wages) and in certain product markets (e.g., special regimes) hinders competition in domestic markets.

High Inequality

Constraints affecting both opportunities and outcomes in the distribution of access to basic services and income create obstacles for many to move out of poverty. A lack of opportunities results in many children not being able to accumulate human capital. When these children grow up, they are less likely to find good jobs and

improve their living conditions. In turn, their children grow up in poor households with low access to opportunities. Specifically:

- Access to, and quality of, basic services is relatively low. Approximately half a million Honduran children do not have access to potable water and 1.1 million children do not have access to basic sanitation. Low levels of access is alarming since these basic services directly affect health and learning outcomes. A quarter of the rural population does not have access to electricity, and only 14 percent of rural adults have an account in a formal financial institution.
- Access is related to household income and location, with children from poor households having limited access to essential services such as education and sanitation. Honduras ranks lowest among LAC countries in the World Bank's Human Opportunity Index (HOI), which calculates how personal circumstances, such as rural status, income, or parental education, impact the probability of a child accessing services necessary to succeed in life, such as schooling, running water, or connection to electricity.
- Formal workers in Honduras benefit from high minimum wages and labor protections; however, 80 percent of workers in the country are in the informal sector, with half of the population relying on self-employment.

Honduras has the highest secondary school dropout rate in Central America due to a combination of high poverty and insufficient secondary schools in rural areas. According to the recent World Bank *Central American Social Expenditures and Institutional Review* these outcomes result from the government's limited ability to expand safety nets, increase the access and quality of public education and health services, engage in active labor market policies, and generally improve human development indicators. This is in part due to low revenues and fiscal deterioration, which constrain the financing of much needed social sector improvements. This highlights that fiscal challenges discussed

in different sections of the report translate into social pressures. Yet, perhaps most importantly, challenges in budget formulation and execution, primarily due to institutional factors, diminish the impact of social spending. Therefore, Honduras needs to significantly improve the effectiveness and efficiency of its social spending.

Low Resilience

Honduras also faces challenges with regards to economic, social, and environmental sustainability.

- On the economic front, achieving fiscal sustainability is critical for Honduras to boost growth and reduce poverty. Honduras benefited from HIPC debt relief, yet its current debt trajectory is pushing it back to its pre-HIPC debt levels, and a large share of domestic revenues goes to debt service rather than productive investments in social development and economic infrastructure.
- On the social front, reducing crime appears to be fundamental. This is because of the negative impact that crime and violence has on the investment climate and investment allocation, and thereby growth, as well as on the social contract that citizens form with the government.
- On the environmental sustainability front, Honduras is highly exposed to natural shocks, which combined with low resilience, affect the poor disproportionately. Some shocks have massive impacts, but a multitude of smaller shocks, including periodic floods and droughts and repeated outbreaks of blight, such as coffee rust ("roya"), have also had substantial cumulative impacts on agricultural production and poverty. The combination of high exposure and low resilience to environmental hazards leaves most Hondurans exposed to frequent income and consumption shocks. Evidence suggests that the poorest households are most affected by disasters; the impact on their assets is both more extreme and more lasting, and prevent the poor from catching up with wealthier groups.

6.2 Deep Roots of the Challenges Faced

The picture that emerges from this discussion indicates that poverty is high and persistent, affected by low growth, high inequality, and sustainability challenges, and in turn, each of these are affected by difficult issues. When there are so many factors that are relevant and that therefore need to be taken into account, any exercise to identify policy priorities that may underlie poverty eradication efforts becomes very complicated. Should one start by addressing the high levels of income inequality because high inequality is itself a barrier to growth and, for a given growth rate, to poverty reduction, or, instead, focus on growth given the low per capita income levels and hence the limits of redistributive policies? And what about the challenges on the sustainability front, given the difficulties of building a long term strategy on footings that are not too solid? And once the decision of which area needs to be tackled first is made, which policy options should be prioritized?

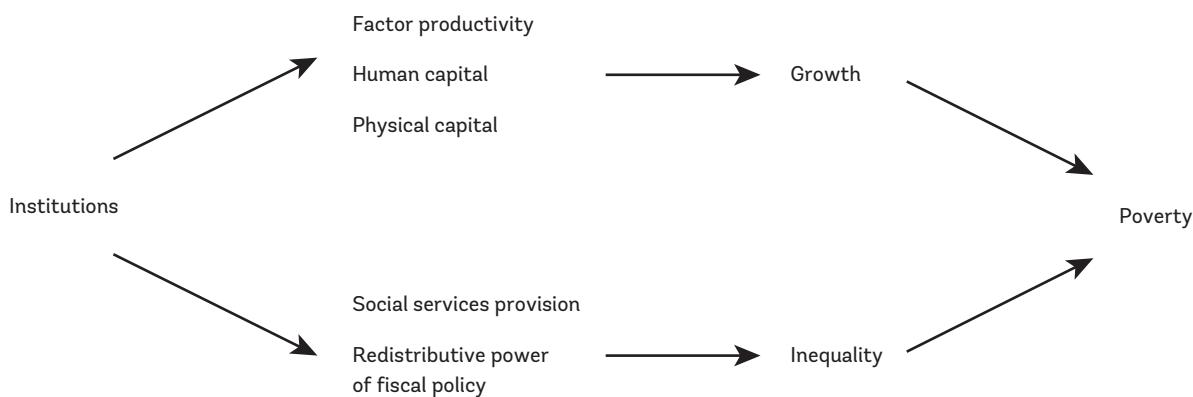
Most of the discussion above has focused on identifying the *proximate causes* of lack of development in Honduras; but is there a root cause? For example, take the case of macroeconomic stability which is a proximate cause behind the country's low growth and a critical element behind the economic sustainability challenges. Achieving macroeconomic stability depends on the quality of policy. Likewise, low levels of education and human capital hinder growth in Honduras and hence the temptation to recommend improvements to education. But education levels (particularly considering that the country already spends a relatively large share of GDP in education) are the outcomes of the set of country policies and institutional arrangements that may be problematic and prevent progress on this front. And consider crime and violence, which appears as a key element underlying low growth and increasing social sustainability challenges, but at the same time is also an extremely complex problem that needs to be tackled taking into consideration factors such as the capacity of the security forces to

enforce the law and/or the judiciary to prosecute crimes. In other words, when considering the identified proximate causes of development in Honduras, could it be that there is a *root cause* affecting the proximate determinants?

The development economics literature highlights the importance of the quality of institutions.¹ North and Thomas (1973) argue that institutions are the fundamental determinant of growth affecting total factor productivity, human capital accumulation, and physical capital accumulation (i.e., the three elements of the production function) and these in turn aggregate income and growth. Shleifer and Vishny (1993) present both a theoretical model and empirical evidence that is consistent with poor institutions affecting the provision of social services, with evidence linking them to outcomes such as infant and child mortality rates, literacy, low birth weight, and primary school dropout rates.² Rodrik (1999) studies other channels and presents evidence from a panel of countries that better institutions are associated with higher real wages and higher labor share in national income. Lindert (1994, 2004) provides evidence from OECD countries indicating a linkage between institutions and public spending, particularly on education. And Acemoglu, Naidu, Restrepo, and Robinson (2015) find that better institutions are associated with higher tax collection as a percentage of GDP. In summary, the existing literature on the role of institutions in economic development suggests that institutional weakness can lead to lower growth (through regulatory framework imperfections, macroeconomic instability, negative effects on human capital accumulation and public infrastructure, access to finance, and more generally inefficiencies of the public sector affecting the implementation of programs), and high inequality (through the governance effects on education and health, and the redistributive capacity of the state). Schematically, these relations are represented in figure 6.1.

One natural question that emerges in this context is what is meant and understood by institutions and their quality. Institutions, both broadly defined as the "rules of the game" and narrowly

FIGURE 6.1 Institutions and Development



Source: Adapted from North and Thomas 1973 and Acemoglu, Gallego, and Robinson 2014.

defined as organizations, particularly in the public sector, pose challenges to development outcomes in Honduras.³ The discussion below relies on a definition of the institutional framework that encompasses notions of: (a) formal and informal rules and regulations (*rules*); (b) the bureaucratic structure that implements and enforces these rules (*capacity*); and (c) and the mechanisms to hold agents accountable for their actions (*accountability*). *Rules* include both formal laws (*de jure* level) and informal rules and regulations. *Capacity* refers to the ability of the administration and society to operate and enact the rules; this includes the delivery of services and the protection of rights and entitlements. And, in this context, *accountability* refers to the mechanisms that shape incentives, including the application of sanctions (or other consequences) if rules are not followed due to a lack of capacity or due to neglect, for example. The configuration of *rules*, *capacity* and *accountability* determine the extent to which the country's institutional framework is conducive to growth, inclusion, and sustainability.

Development outcomes can, in turn, affect the quality of institutions, thereby creating a cycle as illustrated in figure 6.2.⁴ That is, institutional quality is *endogenous* to development outcomes. In other words, poor institutional quality and poor development outcomes can result in a cycle, which can be either vicious or virtuous, and help explain why both poverty and poor quality institutions can be highly persistent overtime. In fact,

FIGURE 6.2 A Cycle between Quality of Institutions and Development Outcomes



Source: Adapted from the proposed framework for the WDR 2017.

there is evidence that differences in institutional quality explain differences in development outcomes over a hundred years later, suggesting that not only is this a strong effect, but also a challenging cycle to break (Acemoglu, Gallego, and Robinson 2014). Indeed, this is the basis for the conceptual framework of the World Bank's forthcoming 2017 WDR, which identifies this feedback loop as a function of the power structure present in society. That is, the bargaining power of different groups (e.g., the middle class, labor unions, business groups) in society influence the quality of institutions.

Development outcomes influence bargaining power, pressuring institutions to deliver; economic growth, for example, results in higher income levels that can increase the demand for better quality institutions (Alonso and Garcimartin 2013). For instance, research using firm data finds that as growth increases the profitability of firms, these are able to escape areas where officials demand bribes and move to areas with lower bribes (Bai et al. 2013). Therefore growth may act as a push factor and low bribes as a pull factor. In practice, this would imply that countries can enter into a cycle where high growth tends to reduce corruption and this feeds back into higher growth, or conversely that corruption negatively affects growth and this feeds back into an increase in corrupting activities. Another potential channel is related to how the level of income inequality affects the quality of institutions. This is attributed to the value of social cohesion and is captured in the importance of a sizeable middle class that demands institutional quality.⁵ In countries with lower income inequality, interests are more closely aligned between groups.

This Systematic Country Diagnostic (SCD) argues that the quality of the country's institutions is an important determinant of development outcomes in Honduras. A question that arises is how to assess the quality of institutions in Honduras, and whether this can be an explanation behind the long-run development challenges in the country. As discussed previously, institutional quality has several dimensions related to the rules in place, the capacity to implement, and the associated accountability framework. For example, problems on the regulatory front (either because of its quality or because it is not appropriately implemented) affect a country's macro stability (Loayza, Oviedo, and Serven 2005, 2006; Satyanath and Subramanian 2004) and through this channel growth. Similarly, lack of capacity in the public sector can lead to inadequate infrastructure provision (e.g., construction of the wrong infrastructure, poor construction and quality of provision, or insufficient maintenance). This in turn can dramatically reduce economic

returns not just for individual projects but to the entire infrastructure stock, and lead to lower levels and less efficient provision of infrastructure provision (Castalia 2004; Dal Bo and Rossi 2006; Estache and Kouassi 2002; Kaufmann, Kraay, and Mastruzzi 2005). And deficiencies in the functioning of the legal system (particularly the quality of courts and their accessibility) that affect enforcement of the rule of law hinder financial sector access for firms, particularly among small and medium enterprises (Love 2009).

International indicators suggest institutional challenges in Honduras. In three of the six indicators reported by the Worldwide Governance Indicators (WGI)—control of corruption, rule of law, and government effectiveness—Honduras scores in the lowest quartile of the world, and in one of those (rule of law) in the lowest decile (figure 6.3). There is no single indicator among the WGI where Honduras is above the world median, though in the case of regulatory quality scoring in the 46th percentile the country is close to it. As for political stability, and voice and accountability, Honduras appears in the lowest one-third of the ranking. If one were to take the average percentile of the six WGI as an aggregate measure, Honduras would be in the 28th percentile, the second lowest in LAC. Findings of weak institutions in Honduras are not unique to the WGI. In its public institutions pillar, the World Economic Forum's (WEF) Global Competitiveness Index ranks Honduras 105th among 144 countries (Error! Reference source not found.). Honduras also ranks low in indicators such as the quality of public spending (127th), the reliability of public services (115th), diversion of public funds (117th), and costs imposed by crime and violence (140th). It is worth noting that both the WGI and WEF indicators have important limitations in their ability to capture the institutional challenges of a country, nonetheless, there is a correlation between these indices which appears to indicate the existence of institutional challenges in Honduras.

The analysis of the bottlenecks to growth, inclusion, and sustainability underscore issues related to institutional quality. Indeed the discussion of

FIGURE 6.3 Honduras' Institutional Quality Indicators Are below Regional Average

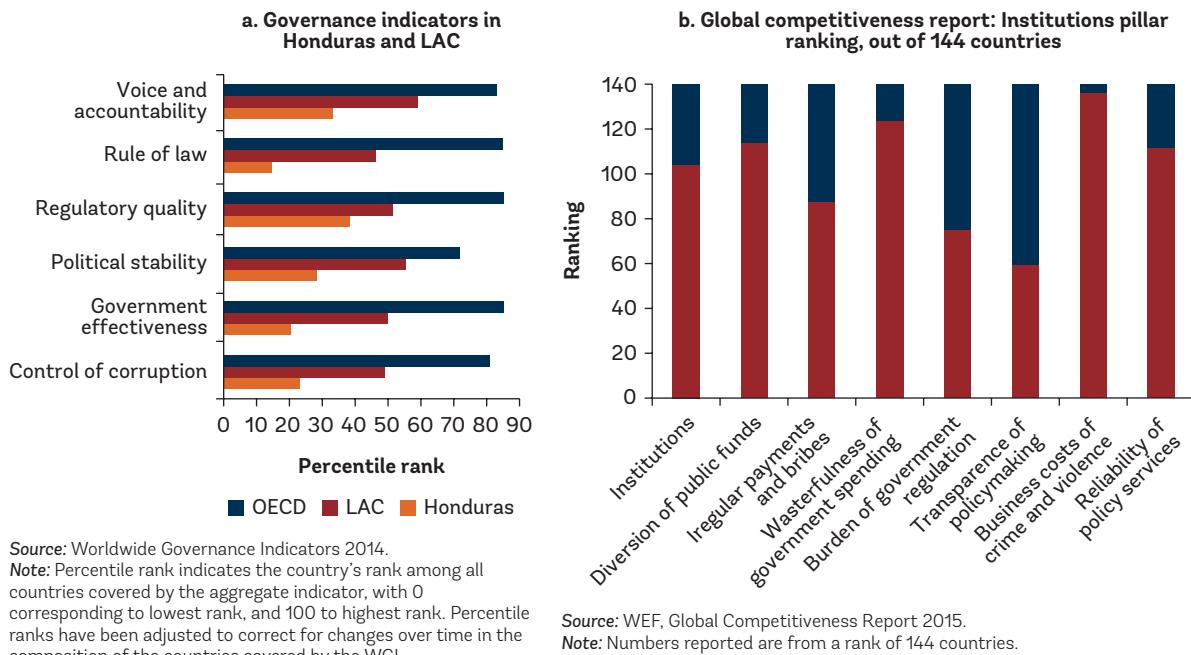


FIGURE 6.4 Proximate and Root Causes of Development Challenges in Honduras



the country development challenges has continuously gravitated towards issues directly related to the quality of institutions (figure 6.4). In the case of inclusion, for example, limited access to basic services and unequal access can be traced back to the country's inefficient public spending as discussed in chapter 4. Furthermore, the country's high minimum wages may be further increasing inequality in the country while potentially harming the

growth of more formal employment. Challenges on the growth side include lack of skills and low infrastructure, two areas also affected by inefficient public spending. Access to capital, including issues affecting property rights, can be traced back to weaknesses in the rule of law. And as regards competition, special regimes and regulations in some markets appear to favor incumbents. All in all, these results are consistent with the discussion emerging from WGI and WEF data. The exception might be the regulatory framework, which according to the indicators of the WGI and WEF does not appear as a top policy priority. Even so, enforcement matters, and, the country analysis concludes that weak enforcement hinder the effectiveness of the rule in critical areas such as citizen security appears as a key constraint to growth and inclusion.

As with the cycles related to crime and emigration, reverting the cycle between institutions and development outcomes cycle is challenging given its self-reinforcing nature. While admittedly it is difficult to present definitive evidence, this SCD argues that a plausible explanation for the high levels of poverty is the quality of the country's economic and social institutions,

which, according to both internationally comparable databases and country-specific evidence, needs to be addressed. This hypothesis would help explain the many factors behind the low levels of growth, high levels of inequality, and sustainability challenges. It would also help explain the persistence of weak institutions and poor development outcomes, as these may be locked in a cycle in which poor institutional quality leads to high poverty and this in turn leads to poor institutional quality. Moreover, this cycle of weak institutions-poor development outcomes would be on top of the two vicious cycles identified previously (high crime and low growth, and large emigration flows and low growth), and feed into them. For example, the low ranking in the rule of law indicator of the WGI suggests difficulties in law enforcement, an area that is critical to fight crime. Likewise, the presence of institutional challenges in the provision of education services, and hence education outcomes would also indicate difficulties in an area that appears key in explaining the challenges that emerge between large emigration flows and low growth.

6.3 Priorities Ahead

Approach to Prioritization

The prioritization exercise undertaken for this analysis is anchored on a number of criteria. First, the exercise considers the extent to which improvements in a particular area would have substantial impacts on tackling poverty and increasing the welfare of the bottom 40 percent of the income distribution. Second, the exercise considers the time horizon of the expected impacts by identifying measures that can generate short and long-term impacts. Third, emphasis is given to the complementarity of the policy areas, in which an identified opportunity in one area could also help address challenges in other areas. Finally, the prioritization exercise gives more weight to areas where the evidence base is stronger.

Noting the difficult development challenges that Honduras faces, the SCD does not discount an

area as a priority solely based on the criteria listed above. Given that the analysis identified the existence of self-reinforcing vicious cycles, priority is given to entry points that could help break those cycles. The basis for this emphasis stems from taking into account areas that complement progress in other areas. Indeed, any effort to inform public discussion of the country's priorities would be remissed if it would obviate actions that would help avoid the significantly negative consequences. This consideration led to a focus on "policy levers" that could help address the vicious cycles. The identified priorities were also informed by consultations with stakeholders and experts in Honduras.

Policy Levers and Complementary Measures

Addressing Honduras' challenges will require a "big push" through coordinated action. In addition to the need to deal with the vicious cycles created by high crime and large emigration and remittances flows, one also needs to consider the role played by the country's institutions as this, through its negative impact on growth, inclusion, and sustainability, creates an additional and perhaps more complex cycle that could keep the country in a low equilibrium. But what does this view of the development challenges in Honduras imply for policy prioritizations?

The analysis suggests three implications to identify priorities ahead.

- A first implication is the need to attack these challenges from multiple angles rather than from a single direction; otherwise the strategy would ignore the reinforcing nature of the different cycles.
- A second implication is the need to identify policy options that can generate a "big push" to break the three cycles.⁶ Marginal interventions are unlikely to break the self-reinforcing dynamics of the different cycles.
- A third implication is that it is critical to find the appropriate policy levers that can help break these vicious cycles (table 6.1). When the focus is on breaking the institutions-poverty vicious cycle, actions aimed at (a) *strengthening of the*

rule of law and the judiciary, building state capacity, and improvements in the accountability framework. Likewise, when the focus is on breaking the crime and violence-growth cycle, actions aimed at (b) *strengthening violence prevention and law enforcement* would appear essential. And when the focus is on breaking the migration-growth cycle, actions aimed at (c) *improving education and skills to compete* are needed so that the increased wage level resulting from high remittances and changes in the real exchange rate is accompanied by increases in worker productivity.

Against this background, there are complementary measures that can support the policy levers. These complementary measures would tackle specific challenges to growth, inclusion, and sustainability. When the focus is on boosting growth, policies that support a competitive business climate, in particular (a) *promoting fiscal sustainability and improving infrastructure and financial intermediation* would be justified. When the focus is on fostering inclusion, complementary measures would include (b) *strengthening the targeting and coverage of social programs* (e.g., CCTs which have proven to be efficient and effective for poverty reduction), *improving access to basic services, and promoting active labor market policies.* And when the focus is on building sustainable

development gains, complementary measures include (c) *building resilience to natural hazards.*

Breaking the Cycle of High Crime and Low Growth: Strengthening Violence Prevention and Law Enforcement

Honduras currently finds itself in a serious wave of violence. While this rash of violence also affects neighboring El Salvador, Guatemala, Belize and Mexico, the situation in Honduras is particularly alarming. Between 2006 and 2011, the country's homicide rate more than doubled from an already high 44 homicides per 100,000 inhabitants, to 92 in 2011, the highest in the world. For reference, in 2012 the global homicide rate was 6 per 100,000. Even as homicide rates have fallen since 2011 to an estimated 67 by 2014, they continue being among the highest in the world and remain particularly high among young men, including a homicide rate of 130 for older adolescents (ages 15–19).⁷ At the same time, there is a high degree of impunity, and the vast majority of homicides remain unsolved. High violence imposes significant economic costs—on the public sector, the private sector, and private households—including income losses, security costs and health costs, even driving some enterprises out of business. It also has significant social costs, with implications for mental health, social cohesion, and educational outcomes.

TABLE 6.1 Priorities Ahead: Policy Levers and Complementary Measures

Policy levers to break or revert the vicious cycles	
Crime and growth	<ul style="list-style-type: none"> • Strengthening violence prevention and law enforcement
Migration and growth	<ul style="list-style-type: none"> • Improving education and skills to compete
Institutions and development outcomes	<ul style="list-style-type: none"> • Improving the quality of institutions through <ul style="list-style-type: none"> - strengthening of the rule of law and the judiciary, - capacity building, and - improvements in the accountability framework
Complementary measures	
Boosting growth	<ul style="list-style-type: none"> • Promoting macroeconomic stability, including fiscal sustainability • Improving infrastructure
Fostering inclusion	<ul style="list-style-type: none"> • Strengthening the targeting and coverage of conditional cash transfers • Improving access to basic services • Promoting active labor market policies to improve job matching, particularly for low skilled workers
Promoting resilience	<ul style="list-style-type: none"> • Strengthening prevention and disaster risk management

Reducing crime and violence would yield positive results for growth, inclusion and sustainability. For instance, lower security costs and fewer cases of extortion would increase the profitability of enterprises and small businesses, boosting growth and leading to the creation of more job opportunities.

Addressing crime and violence requires an integrated agenda. Tackling crime and violence requires raising the opportunity costs of crime through increased law enforcement (which increases the expected costs of criminality) and prevention through better opportunities (which decrease the relative payoff of criminality). That is, crime prevention must be thought of as a set of broad interventions that go beyond law enforcement and security measures so as to address the root causes, including the country's lack of opportunities. Thus, it is important to connect crime prevention interventions with the underlying causes of criminal activity by addressing perceptions of impunity, youth exclusion and general poverty. This calls for capacity building for national, regional and local authorities and alignment of strategies as well as coordination across sectors such as health, education, and criminal justice. Effective prevention strategies address multiple risk factors and across multiple levels (individual, family, community, society). Because violence tends to concentrate geographically, prevention is more effective when it engages communities and connects them to regional and national prevention strategies. Social networks at the community level can be effective in reducing violence and addressing the perceptions of safety and trust.

Another consideration is that crime prevention should also address the need for rehabilitating citizens committing acts of violence. Many former gang members and drug traffickers would need to be reintegrated into society for the sustainable prevention of violence. From law enforcement to the judiciary to the penitentiary, programs must focus on holistic approaches to prevention, intervention and rehabilitation activities. One example of a program that has proved successful at preventing crime is the *Programa de Apoyo Temporal al Empleo* (PATI) implemented in El Salvador. This program offers income support to vulnerable individuals in

urban areas with program beneficiaries committing to participate in community activities and capacitation programs to improve its employability and entrepreneurial abilities. The World Bank supported a similar cash for work project in Honduras, *Employment Generation in Poor Urban Neighborhoods*, which targeted at risk youth and unemployed heads of household with young children. This project also included a number of crime and violence prevention training and development of human capital, including conflict resolution and preparation for employment. These type of programs have the effect of increasing the opportunity cost of joining a criminal group by increasing both the present income and the future potential income of those enrolled. Initial impact evaluations in El Salvador show that PATI contributed to lowering the levels of crime in the communities where it was implemented.

Breaking the Cycle of High Emigration and Low Growth: Improving Education and Skills to Compete

Educational access and quality in Honduras is relatively low and improving it will help boost long term growth and poverty reduction. The country's test scores are low and fewer than half of secondary school aged children are enrolled in school. While a lack of access to quality schooling exacerbates inequality and limits intergenerational mobility, it also poses a challenge for growth with 28 percent of firms identifying a lack of skilled workers as a major constraint according to the 2010 Enterprise Survey. The combination of a small skilled labor force and the upward pressure on wages resulting from the high levels of remittances received in Honduras has fed into relatively high wages for skilled labor even as, overall, wages have remained flat and labor outcomes are weak for the average Honduran. Better quality and more accessible education would enable more Honduran workers to better acquire the skills necessary to compete for higher productivity employment thus alleviating the pressure of high wages.

To foster more skills, a priority for Honduras is improving the quality of basic schooling and, in

particular, addressing the country's secondary school dropout rate. Access to primary and secondary schooling of good quality is essential as it provides the basic building blocks necessary for learning more advanced skills. In the short-run, it is also important to build skills in the current workforce. Some possibilities include vocational training for adults, including technical skills and English skills, so that more workers can participate in skilled tradable sectors, opening the door to a more diverse set of exports so that the country can reap the rewards of its strategic geographical location. Since agriculture continues to play a prominent role in Honduras and employs a large share of the poor and the bottom 40 percent, it is also important to improve agricultural and agribusiness skills (for example, the adoption of new technologies to improve output, and technical skills needed to connect to larger markets) that can lead to improved income opportunities for rural households.

Improving Institutional Quality: Strengthening of the Rule of Law and the Judiciary, Building Capacity, and Strengthening the Accountability Framework

A central question regards how to strengthen institutions beginning with improving the rule of law and the capacity of the state. Tackling corruption requires addressing gaps in the accountability framework. The 2009 World Bank's Institutional and Governance Review (IGR) identified the need to strengthen the country's accountability framework and in particular, the accountability of policymakers towards citizens and tax payers. The IGR suggested three key recommendations that could represent important steps towards improving accountability and governance conditions in Honduras: (a) Improving transparency in key policy- and decision-making processes; (b) Strengthening mechanisms to hold policy- and decision-makers to account, especially in cases of poor performance; and (c) Supporting citizen groups representing the broader public interest, to participate in policy discussions.

The Honduran authorities have undertaken a self-assessment which identifies a number of priorities to combat corruption and improve the rule of law. A self-assessment of United Nations Convention on Anti-Corruption (UNCAC) Chapter III on Criminalization and Law Enforcement and chapter IV on International Cooperation has revealed that, with few exceptions, the legal framework of Honduras complies with most provisions of the UNCAC in relation to criminalization of bribery and with most requirements relating to international cooperation by signing a series of international treaties, which are now part of domestic law.⁸ However, the self-assessment reveals that major challenges remain in terms of law enforcement. The number of investigations, prosecutions and conviction for crimes such as domestic bribery, bribery, embezzlement, and trading of influence are low. According to statistics from the Honduras Electronic Judicial Center for Documentation and Information (CEDIJ), the Sentencing Courts prosecuted only 16 cases related to bribery in 2012–14. Ten cases ended with convictions and 6 in acquittals. During the same time period, there were 17 investigations related to illicit enrichment, only one led to prosecution. The self-assessment identifies weaknesses in the criminal justice system and lack of capacity to conduct robust investigations and obtain evidence as the main reasons to the poor enforcement of the laws. The Self-Assessment also reveals that the National Anti-Corruption Agency (CAN) needs institutional support, and that there is demand for technical assistance in drafting new legislations as per the gaps identified in the legal framework; developing a registration, monitoring and evaluation system for corruption crimes; and establishing IT-enabled asset declaration system. It also reveals Public Prosecutor's need for capacity building support in investigation techniques and forensic audit, and management of crime statistics from the relevant authorities.

To address these challenges, the Honduran self-assessment of chapters III and IV of the

UNCAC revealed specific areas to strengthen the legal, regulatory and institutional framework for enhancing accountability and enforcing the rule of law. Major gaps identified in the legal framework include: 1) lack of necessary provisions on transnational bribery of foreign public officials and officials of public international organizations; 2) Laws criminalizing trade in influence do not cover “the promise, offering or giving to a public official of an undue advantage” or “solicitation or acceptance by a public official of an undue advantage”; 3) the criminal code does not include a definition of bribery in the private sector; 4) obstruction of justice is not explicitly defined as a crime in the legal framework; 5) responsibility of collaborators or instigators is not covered by the legal framework; 6) there is no specific provision establishing the possibility of mitigating penalties in the case of cooperation on the part of the accused; and 7) extradition law is incomplete and only offenses related to organized crime, drug-trafficking and terrorism allow for extradition of Honduran nationals. At the same time, the self-assessment also revealed gaps in enforcement, including a witness protection program that, by law, only extends to individuals who have appeared in court and excludes those who are in the preparatory stage of trials.

Administrative simplification can also support improvements in the rule of law. Bribe payments are the outcome of a wide range of factors and country circumstances that breed corruption, rather than a policy variable that can be changed at the will of policy makers (Alaimo et al. 2009). One of the hypotheses, known in the literature as the “control rights” hypothesis, considers the possibility of unscrupulous public officials exerting an implicit control on firms to obtain bribes. This control would stem from the inherent features of complex rules (which in turn can be related to the quantity and quality of regulation, either de jure or de facto) and the discretionary power of officials enforcing those regulations. The second hypotheses, known as the “grease the wheels” hypothesis, would postulate that firms may have incentives to bribe officials to skip regulations or to secure contracts. In practice, there is evidence

of both of these behaviors present in most countries with high prevalence of corruption, as well as evidence that the country’s general attitude toward corruption is a strong determinant of the incidence of bribes (Alaimo et al. 2009).

Improving institutional quality will require actions along the three dimensions—rules, capacity and accountability; that is, there is a need to develop effective rules to boost growth, inclusion and sustainability while at the same time building capacity to enforce these rules and hold agents accountable. It is important to review the regulatory framework to create incentives that benefit the public interest. Good rules, however, can suffer from bad enforcement because of overly cumbersome procedures, lack of qualified personnel, or weak accountability mechanisms. Thus, administrative simplification, together with a more professional civil service (which in turn will help improving the capacity of the state), can be an effective tool for lowering the cost and improving the efficiency of regulations, thereby increasing compliance and reducing the opportunities for corruption or rent seeking. Moreover, it is important to improve enforcement and accountability, such as by increasing efforts to monitor compliance and raising the costs of regulation infringement by adequately levying fines and sanctions. To achieve this, strengthening the judicial system is essential; for example, increasing the likelihood of punishment for both parties engaging in a corrupt agreement (thus increasing the expected cost of entering into such agreements) is likely to lead to lower corruption levels.

Complementary Policies to Support the Policy Levers

Addressing Honduras’ challenges would also require looking beyond the cycles and focus on policies that foster growth, inclusion, and sustainability. The policy levers, identified as entry points to tackling the cycles, can be complemented with measures aimed at (a) reigniting economic growth; and (b) fostering inclusion. Note that these type of policies would be fully

justified not only because of their static impact on poverty reduction and shared prosperity but also because of the impact that they have on the identified country development dynamics, with higher growth feeding into lower crime and lower migration pressures and hence these feeding back into future higher growth, and with higher growth and lower inequality feeding into better institutions and these in turn into higher growth. Lower inequality would also contribute to lower crime rates. Indeed Fajnzylber, Lederman, and Loayza (2002) present empirical evidence suggesting that even though criminal inertia is quite significant, declines in income inequality lower crime rates (this in addition to the beneficial impacts on crime levels of economic growth). Interestingly a second round effect of a lower inequality induced lower-crime-rate would be lower migration flows.

What are the policies that could be expected to have the highest impact on growth over the medium-term? The discussion in this report suggests that there is no trivial answer to this question but rather that tackling the bottlenecks to growth that cut across sectors will be key. For example, the impact that the macroeconomic instability during 2012 and 2013 had on the investment climate highlights the need for ensuring fiscal sustainability as a necessary but not sufficient condition for reigniting economic growth. A stronger fiscal position that is achieved now and sustained over the medium to the long-term will set the basis for progress on service delivery, and growth and employment. Fiscal deficits and slower economic growth since the 2009 crisis have increased public debt, reaching a concerning level and possibly affecting investment decisions. While the authorities have recently made strides to reduce the fiscal deficit, fiscal consolidation will require additional reforms that enhance public financial management and rebalance expenditures from current spending towards capital spending. Curtailing the fiscal losses in the power sector will also bolster the fiscal position, and in this regard the current environment of low oil prices does provide an opportunity to advance electricity pricing reform. At the same

time, there is scope for mobilizing additional tax revenues by improving tax and customs administration and reducing tax exemptions which represent a large share of GDP.

With a view to generating sustained growth and facilitating further insertion into the global markets, it is important to address the constraints of expensive and low quality infrastructure services. As mentioned, a focus on the energy sector is warranted. Key objectives include: (a) improving energy pricing and energy efficiency mechanisms, such as modernizing the energy matrix towards cleaner and cheaper energy sources to reduce the dominance of thermal power; (b) improving the legal framework to reduce fraud and theft; and (c) strengthening the corporate governance of the state-owned electricity company, including building capacity at the newly created energy regulatory agency. Regarding transport, a focus on port infrastructure and improved road maintenance—both which could benefit from the development of public-private partnerships that bring private sector participation—is warranted and should be combined with improved logistics and regulations to reduce waiting times while improving customs enforcement. These investments, if planned and executed well, also represent an opportunity for growth in the near term, providing opportunities for Public Private Partnerships and the creation of jobs.

These proposed measures to boost growth would support the private sector and help generate more demand for labor, creating jobs. To the extent that a healthy fiscal environment leads to less macroeconomic volatility, this would reduce the frequency with which the private sector must absorb severe shocks. Reducing operating costs through improvements in the energy sector and transportation would boost productivity. Meanwhile, improving financial intermediation including policies designed to promote increased savings of remittances in the formal financial sector is expected to increase overall savings, and the improved access to finance would particularly benefit SMEs and young firms, the source of a disproportionate share of job creation in Honduras. Combined with the

policy levers designed to address the cycles of crime, emigration, and institutions identified above, these measures would be expected to promote a better business climate and lead to more job creation by the private sector.

The challenge of fostering inclusion cannot wait for the indirect effects of growth and employment creation. As noted, 80 percent of Honduran children live in poverty and a majority do not finish secondary school. There is strong evidence that the current social assistance programs (CCT) are having an impact in the reduction of poverty and should be expanded to cover all eligible extreme poor. Over the long-term, efforts at inclusion need the support of basic services of good quality that empower the population with the assets both to create and to profit from opportunities. Besides the attention to education and skills, already noted, reducing child malnutrition should figure as a high priority. A solid insertion into the labor markets is the best bet to a sustainable inclusion. This would call for active labor market policy that rather than focusing on minimum wages emphasizes making the markets work, by addressing issues of information, tailored skills, and linking with job creation. Minimum wages in line with the market have the potential to unleash investment and production in high productivity sector and contribute to a better allocation of resources in the economy. Addressing skills and information problems can be conduit of improving employment opportunities for the young and poor and be a countervailing force to violence and crime.

There is also a need for measures focusing on addressing vulnerability. For this, it will be critical that Honduras continues building resilience to natural disasters as these are expected to increase

in frequency and severity with climate change. There is already in place an ample agenda under implementation for building institutions and improving infrastructure and local planning. Greater attention is needed, however, to the impact of “small” natural events that affects the lives of the poor in a localized but dramatic manner. In this regard, the capacity of households to manage the impact of natural disasters can be enhanced by linking them to saving mechanisms and increasing the availability of financial instruments, such as agricultural insurance. Additionally, improved management of natural resources, particularly water, can help protect households and agricultural production from the effects of droughts. This is particularly key in the Dry Corridor, an area of the country characterized by 4–6 months of almost no precipitation and low water availability.

Conclusion

Honduras is a country with great potential; unlocking these potentials will foster the creation of greater opportunities for its citizens. It has a young population, is rich in natural resources, is geographically well-located and open to trade, and already attracts high inflows of private investment. Yet, it is also a country facing long-term and pressing challenges, particularly a self-reinforcing cycle between weak institutional capacity and low development underlying the self-reinforcing cycles between low growth and high crime and large emigration flows. To address these cycles the agenda is highly complex and will require a long-term commitment and a high level of political consensus. The priorities identified in this Systematic Country Diagnostic focus on breaking these cycles to bridge the gap between potentials and actuals.

Notes

1. Admittedly, the empirical literature on the impact of institutions on development has not produced refined enough results to assess the magnitude of the effects of institutions on growth and income inequality. In some cases, this has been due to difficulties finding exogenous variables that can

be used to instrument explanatory variables measuring the quality of institutions. In others, because of the intrinsic difficulties at capturing the different dimensions of the quality of the institutions. And finally, there are also problems distinguishing the differences between *de jure* and

- de facto institutions. Yet, the causal relationship linking institutions to development appears well documented.
2. Kaufmann, Kraay, and Zoido-Lobaton (1999) find that a one standard deviation improvement in the Worldwide Governance Indicators was associated with a two-and-a-half to four-fold decrease in a country's infant mortality rate, and a 15 to 25 percent increase in literacy. Similar results are obtained by Gupta, Davoodi, and Tiongson (2000) who also find that corruption has adverse consequences for a country's child and infant mortality rates, percent of low-birth weight babies in total births, and dropout rates in primary schools. In particular, child mortality appears to be about one-third higher in countries with high corruption, and infant mortality rates and the percent of low-birthweight babies almost twice as high. Dropout rates are five times as high.
 3. North (1994) refers to institutions as "humanely devised constraints that structure human interaction... made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics." He defines organizations as "made up of groups of individuals bound together by some common purpose to achieve certain objectives... [they] include political bodies (e.g., political parties, the Senate, a city council, regulatory bodies), economic bodies (e.g., firms, trade unions, family farms, cooperatives), social bodies (e.g., churches, clubs, athletic associations), and educational bodies (e.g., schools, universities, vocational training centers)."
 4. The applied economics literature has typically considered institutions endogenous to the development process, an implicit recognition of the feedback loop. Yet, similar to the difficulties of quantitatively estimating the effects of institutional quality on development outcomes, the estimation of the effects of development outcomes on the quality of institutions faces the same statistical challenges that limit the ability to parametrically assess the impact in practice.
 5. For example, Loayza, Rigolini, Llorente (2012) and Ferreira et al (2013). Alonso and Carcimartin (2013) argue that income distribution 1) "...causes divergent interests among different social groups, lead(ing) to conflicts, sociopolitical instability and insecurity"; 2) "... facilitates that institutions remain captured by groups of power"; and 3) "diminishes social agents' disposition to cooperate action and favors corruption and rent-seeking activities."
 6. This implication was also presented in the Systematic Country Diagnostic for El Salvador (see Calvo-Gonzalez and Lopez 2015), the neighboring country that also faces the vicious cycles related to high levels of crime and migration.
 7. Observatorio de la Violencia de la Universidad Nacional Autónoma de Honduras (UNAH).
 8. The World Bank entered into a partnership with the United Nations Office of Drugs and Crimes (UNODC) in March 2015 for implementing UNCAC in selected countries and Honduras was selected as the first country where this partnership would be piloted. The UNCAC requires that states establish and promote effective practices aimed at preventing corruption, to establish criminal and other offences to cover a wide range of corrupt acts, to cooperate with one another in every aspect of the fight against corruption, and to support each other in the recovery of stolen assets. UNCAC is the only legally binding universal convention on anti-corruption and in many respects represents an accepted international standard regarding best practices for combating corruption. The UNCAC Self-Assessment is an objective and evidence-based instrument to assess the gaps in the legal, regulatory and institutional framework for combating corruption. It provides a comprehensive overview of the policies, legislation, institutions and implementation capacities. The National Anti-Corruption Council (CNA) is the Focal Point nominated by the government to conduct the Self-assessment. The UNCAC Self-Assessment of Chapter II on Prevention of Corruption and Chapter V on Stolen Asset Recovery is about to start.

Appendix A

Definition of Peer Countries

In order to compare Honduras' performance, the analysis features six comparable groups of peers: Central American countries, Latin American peers, lower middle income countries, the World, structural peers, and aspirational peers. In the case of the former two, both groups were prepared using the "Find your friends" tool, which is mainly based on the World Economic Outlook (WEO) database.

Structural Peers

Under this classification, countries with similar characteristics to Honduras were identified using the following criteria for the period 2001–13:

- Lower middle income countries
- Population between 3.0 and 15.0 million
- No land-locked
- No fragile state
- Manufacturing share higher than 10 percent

This classification delivers the following group of countries:

Structural peers	Population (million)	GDP per capita PPP (US\$)	Manufacturing share (%)
El Salvador	6.4	4,992	20.4
Georgia	4.5	2,411	14.1
Honduras	8.3	3,152	19.1
Moldova	3.6	1,608	13.6
Nicaragua	6.2	2,846	16.4
Senegal	14.5	1,395	14.2

Source: World Economic Outlook.

Note: Average data for 2001–13.

Aspirational Peers

This classification aggregates countries that may be used as good examples of development for Honduras using the following criteria for the period 2001–13:

- Lower middle income and upper middle income countries
- GDP per capita growth higher than 3.0 percent
- Inflation below 5.0 percent
- Credit risk rating better than B+
- Population below 35 million.

This classification delivers the following group of countries:

Aspirational peers	Population (million)	GDP per capita PPP (US\$)	Real GDP per capita growth (%)	Inflation (%)	Credit risk rating
Armenia	3.3	4,471	7.5	4.6	Ba2
Chile	17.7	14,244	3.3	3.1	AA-
Honduras	8.3	3,152	1.9	7.2	B+
Latvia	2.0	14,448	5.5	4.7	BBB+
Lithuania	3.0	16,385	5.9	3.0	BBB
Morocco	33.2	4,118	3.6	1.7	BBB-
Panama	3.8	10,632	5.3	3.2	BBB
Peru	31.4	7,806	4.1	2.6	BBB

Source: World Economic Outlook.

Note: Average data for 2001–13.

Appendix B

Poverty Measurement in Honduras

To measure the incidence of poverty, Honduras uses two income-based poverty lines. First, the extreme poverty, or “food poverty”, line reflects the cost of a locally obtained basic food basket that meets minimum caloric requirements. Second, the overall poverty line is constructed by taking the extreme poverty line and adding a set of basic nonfood goods. These lines are priced differently for rural and urban areas to account for differences in the cost of living. Using the national household survey, income estimates are constructed at the household level, which include both labor and non-labor income. This aggregate income is adjusted by a factor to correct for under-reported incomes. The adjusted household income is then divided by the number of household members to obtain the household income per capita.

It is important to take into account the following considerations when comparing poverty measurements in Honduras. First, the methodology used to adjust for non-declaration of income is not clearly documented and may be outdated. Since a large share of households rely on informal employment, including a significant share of households relying on subsistence agriculture, measuring income is not always straightforward. Second, different poverty lines are used for urban and rural areas, but it is not clear that there are spatial differences in cost of living as there is no information on rural prices. Third, the poverty rate is reported as the share of households living in poverty, not as a headcount. To the extent that poor households have more members, this yields a lower poverty rate than a headcount measure.

During the last decade, the headcount poverty rate has been on average six percentage points higher than the household poverty rates: in 2013, for example, using both the extreme and the moderate poverty line the headcount was 5.5 percentage points higher than the household poverty rates. Finally, the real value of the urban poverty line may be set too high when compared to other countries in Central America, such as Costa Rica or Panama, which have a higher gross domestic product (GDP) per capita than Honduras (Cadena et al. 2013). Specifically, Honduras’ urban poverty line is the equivalent of \$8.90 per day (2011 PPP), second only to Uruguay in the Latin American and Caribbean (LAC) region.

To measure poverty across countries, the World Bank Group and its partners have developed comparable welfare aggregates and international poverty lines. The figures produced by the Honduran authorities reveal the evolution of nationally-defined poverty indicators over time. However, poverty lines and estimation techniques vary between countries, resulting in poverty estimates that are not internationally comparable. The comparable figures, on the other hand, enable international comparisons and benchmarking. Hence, all cross-country analyses presented in this report are based on these international lines. For Honduras and other countries in LAC, the source of comparable household surveys is the SEDLAC project, a joint project of CEDLAS, at the National University of La Plata in Argentina, and the World Bank Group.

Appendix C

Outcomes of the Poor Have Improved between 2003 and 2013

TABLE C.1 Profile of the Poor and Non-Poor in Honduras, 2003–13

Characteristics	2003				2013			
	Extreme poor	Poor	Non poor	All	Extreme poor	Poor	Non poor	All
Household								
Percentage in each category	50.9	70.0	30.0	100.0	48.2	70.1	29.9	100.0
Daily per capita income (2005 US\$ PPP)	1.8	2.6	13.3	6.4	1.7	2.6	13.3	6.4
Average household size	5.7	5.5	4.0	5.0	5.0	4.8	3.7	4.4
Average age of household head	46.6	45.8	43.6	45.0	49.2	49.1	49.2	49.2
Households with female head (%)	22.3	23.5	21.6	22.8	32.0	33.6	32.0	33.1
Living in urban area (%)	30.3	43.7	60.0	49.6	33.1	45.6	54.9	48.9
Average years of education of household head	2.8	3.5	6.9	4.7	3.6	4.2	7.7	5.4
School enrolment (% of ages 12–18)	50.2	53.7	67.6	57.6	49.7	53.8	65.8	56.8
School enrolment (% of ages 6–12)	78.7	79.8	86.5	81.3	91.2	92.4	97.1	93.3
Proportion of members 0–12 years old (%)	38.7	36.5	22.7	31.6	30.9	28.4	15.6	23.8
Proportion of members 13–18 years old (%)	13.9	14.0	11.5	13.1	15.0	14.9	11.1	13.6
Proportion of members 19–70 years old (%)	43.8	46.1	63.1	52.2	47.9	50.5	66.2	56.1
Proportion of members 70+ years old (%)	3.6	3.4	2.6	3.1	6.2	6.2	7.1	6.5
Labor force (ages 18–65)								
Female labor force participation (%)	32.8	38.2	60.7	46.4	37.1	42.5	63.0	49.8
Male labor force participation (%)	91.1	91.1	92.1	91.5	92.3	91.0	89.1	90.3
Unemployment rate (%)	4.6	5.2	3.2	5.1	4.6	4.8	2.6	3.9
Female	6.4	6.9	3.6	5.3	6.9	6.5	2.9	4.9
Male	3.9	4.4	2.9	3.8	3.6	3.8	2.4	3.3

Source: World Bank estimates based on SEDLAC (CEDLAS and the World Bank). Poverty status based on official poverty lines.

Appendix D

Labor Force Participation Correlates, 2013

TABLE D.1 Labor Force Participation Correlates, 2013

	Rural		Urban	
	Women	Men	Women	Men
Dummy of remittances (1 = receives)	-0.0875*** (0.0264)	-0.0688*** (0.0196)	-0.119*** (0.0216)	-0.0198 (0.0165)
Amount of government transfers per capita	-0.00251 (0.00188)	-0.00193 (0.00287)	0.000615 (0.000473)	-0.00147 (0.00136)
Homicide rate of the department	-3.81e-05 (0.000494)	-0.000368* (0.000214)	-0.000558* (0.000327)	0.000132 (0.000202)
Another member of HH is working	-0.111*** (0.0305)	-0.0206*** (0.00764)	-0.0431** (0.0204)	-0.00403 (0.0105)
Primary & less than secondary	0.0899*** (0.0199)	0.0162** (0.00781)	0.0643*** (0.0207)	0.0260* (0.0138)
Secondary and more	0.303*** (0.0360)	0.0102 (0.0200)	0.195*** (0.0217)	0.0150 (0.0158)
Marital status (1 = married)	-0.178*** (0.0202)	0.0788*** (0.0133)	-0.139*** (0.0159)	0.115*** (0.0139)
Number of children	-0.0106** (0.00539)	0.00538** (0.00234)	-0.0140** (0.00587)	-0.000453 (0.00355)
Age	0.0482*** (0.00641)	0.00103 (0.00295)	0.0553*** (0.00558)	0.0235*** (0.00411)
Age squared	-0.0005*** (7.39e-05)	-0.0005 (3.44e-05)	-0.0006*** (6.42e-05)	-0.0003*** (4.86e-05)
Constant	-0.423*** (0.139)	0.922*** (0.0583)	-0.414*** (0.122)	0.428*** (0.0868)
Observations	2,960	2,607	3,922	2,977
R-squared	0.087	0.053	0.089	0.078

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM. Regressions are linear probability models estimated for individuals aged 25–65 by gender and area (rural/urban). All regressions control for region-fixed effects. Homicides rates are not available for 2003.

Note: Robust standard errors in parentheses. ***p<0.01, **p<0.05, *p<0.1.

Appendix E

Emerging Research Area: What Has Been Affecting Low Returns to Investment in Honduras?

Supported by strong inflow of foreign direct investments (FDIs), Honduras investment ratio to gross domestic product (GDP) has been consistently high by regional standards. From 1990 to 2014, investment as a share of GDP averaged 23.5 percent, higher than the LAC, OECD and World average (22.2, 21.7 and 22.6, respectively). The growth in investment has been driven by the private sector, while public investment has shrunk. FDI inflows played a significant role in expanding investment opportunities, especially since 2000s, driven by large investment in telecommunication infrastructure and maquila sector. Both telecommunications and maquila sectors accounted for 53 percent of the total FDI between 2001 and 2013, a total of almost US\$5 billion in 13 years.¹ As a result, the share of FDI in investment went up from 6 percent in the 1990–99 to 22 percent in 2000–13 (figure E.1).

The high levels of investment have not translated into high rates of economic growth. Over the past two decades, investment as a share of GDP has averaged 25.5 percent, compared with real output growth averaging only 3.6 percent per year (figure E.2).² In contrast, during the same period, other lower middle income countries had average rates of investment of 23.1 percent of GDP with an average growth rate of 5.1 percent per year. In other words, for each unit invested in Honduras, the growth generated has been lower than in peer economies. This represents a high investment/low growth paradox.

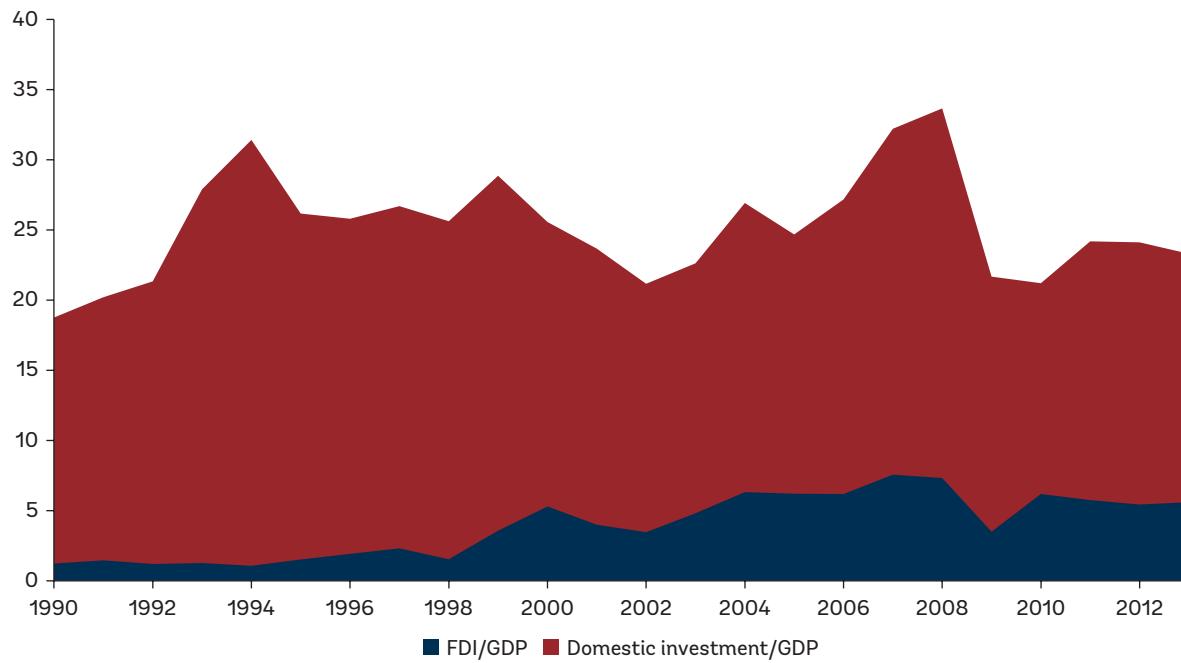
Inefficiencies in the sectoral allocation of investment and the high costs of investment could be behind the low returns to capital. Honduras has registered high levels of investment and large FDI inflows despite the fact that total returns to capital

are lower than in other comparable groups. Over the 1990s, returns to factor investments have gradually deteriorated (figure E.3) and have remained below the average return for Central America and other countries.³ Evidence suggests that high misallocation of capital among sectors, high costs of doing business, low value-added industrial activity, unsophisticated value chains with access to international markets (with some exceptions i.e. textiles, automotive parts, among few others), inefficient public investment and regulatory structures, and limited investment spillovers on the economy may be eroding the possible growth impact from Honduras' high levels of investment.

A large share of private investment in residential construction might be a sign of possible capital misallocation. Within the private sector, residential construction represents around 25 percent of the total investment, of which 20 percent is self-construction (figure E.4). The importance of residential construction in Honduras stands out as compared to other benchmark countries and may explain the higher ratio of investment in GDP. In addition, this type of investment exhibits lower returns to investment relative to commercial or industrial construction as well as more capital intensive sectors. When purchases of machinery and equipment increased in 2000–13, the decline in the return to capital leveled-off, indicating that the low returns to capital might be associated with capital misallocation towards residential construction.

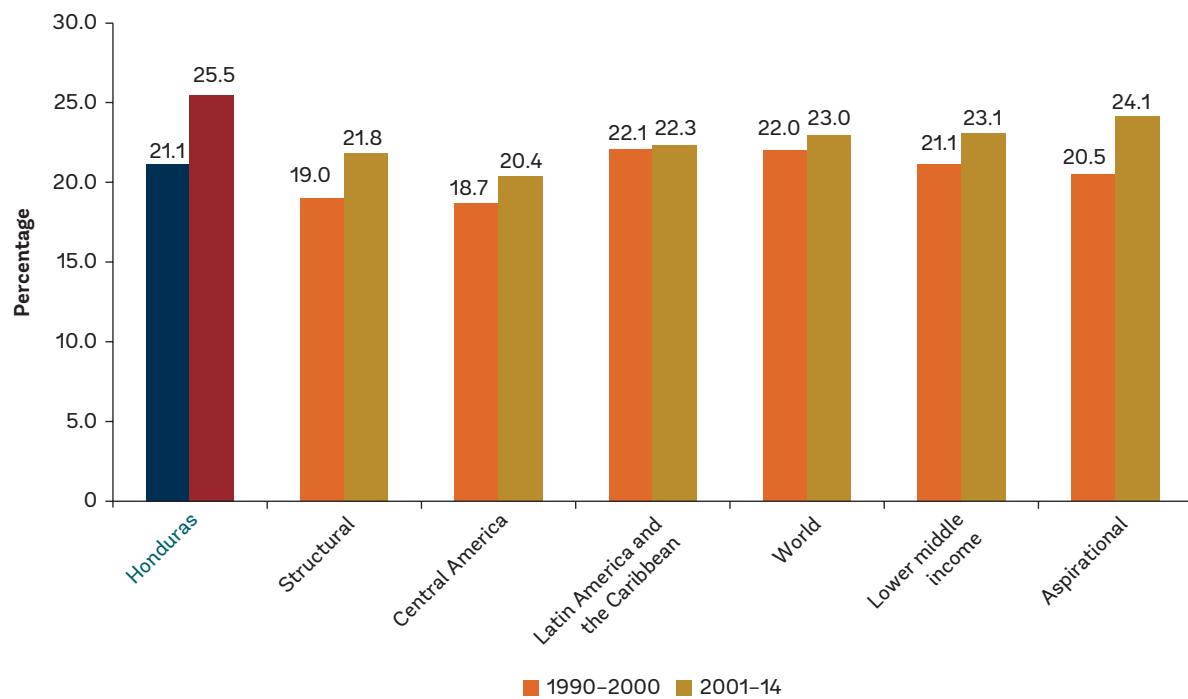
Adjusting levels of investment by purchasing power parity (PPP), Honduras' investment share in GDP decreases, indicating that investing in the country may be costly. Although Honduras

FIGURE E.1 Honduras' FDI Has Grown Significantly Since 2000
(*Investment-to-GDP ratio*)



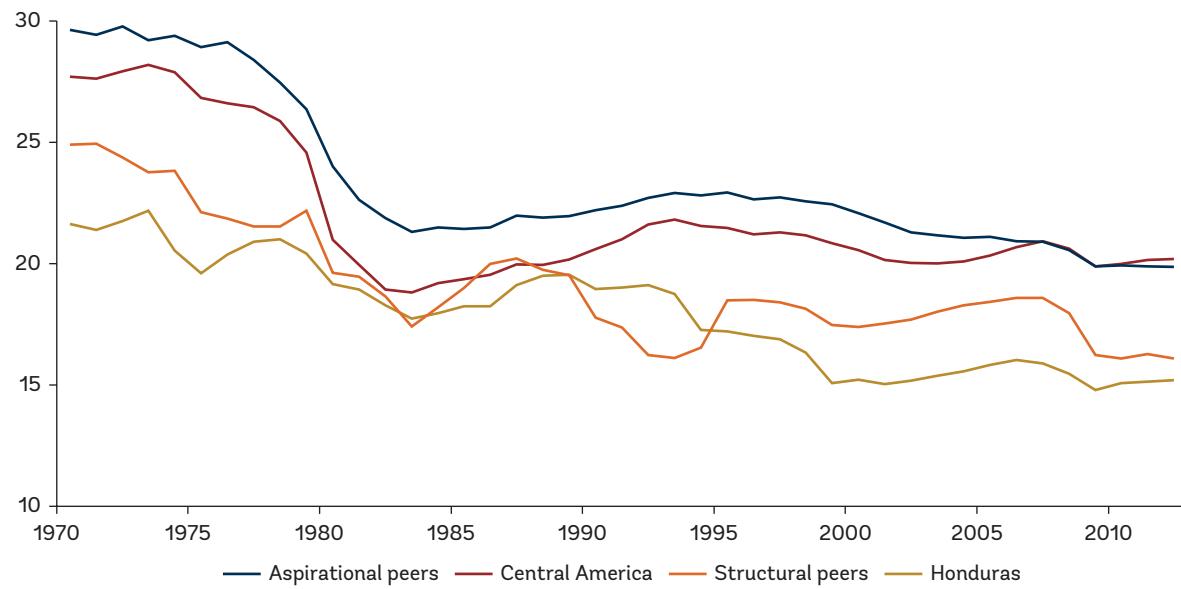
Source: UNCTAD, World Economic Outlook, World Bank estimates.

FIGURE E.2 Honduras' Investment-to-GDP Ratio Has Been Higher Than That of Its Regional Peers
(*Investment-to-GDP ratio*)



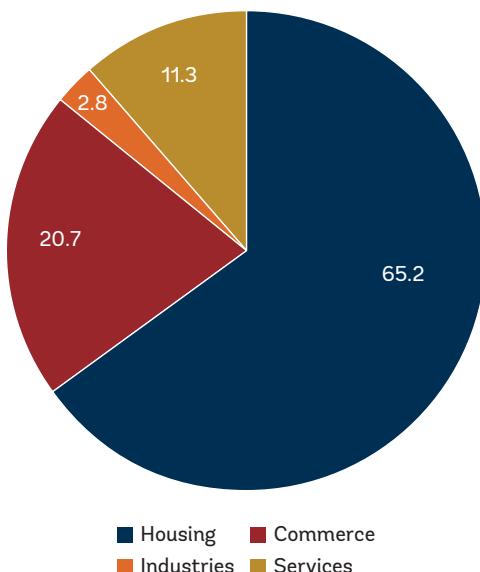
Source: World Economic Outlook, World Bank estimates.

FIGURE E.3 Returns to Capital Have Been Consistently Lower in the Last Four Decades
 (Average rate of return to capital)



Source: World Development Indicators, World Bank estimates.

FIGURE E.4 Investment in Construction Is Highly Concentrated in Residential Investment
 (Construction, by sector, 2008–13)



Source: Honduran authorities, World Bank estimates.

investment levels are still higher than in other comparable countries, focusing on relative price of investment suggests that Honduras could improve investment quality and its spillovers not only by reducing barriers to investment (business climate constraints), but also by reducing the relative price of investment (see Hsieh and Klenow 2007). Why is it costly to invest in Honduras? As elaborated in chapter 3 under “Challenges to Competitiveness in Honduras,” high costs of investment in Honduras are associated with issues of low human capital and labor costs, infrastructure, access to finance, ease of doing business, security, and macroeconomic and political instability, all of which impose additional costs to firms operating in the country. For instance, the lack of a qualified labor force and the relatively expensive wages, as well as high costs of energy in industries such as *maquila* partly explain the lower investment returns in these sectors.

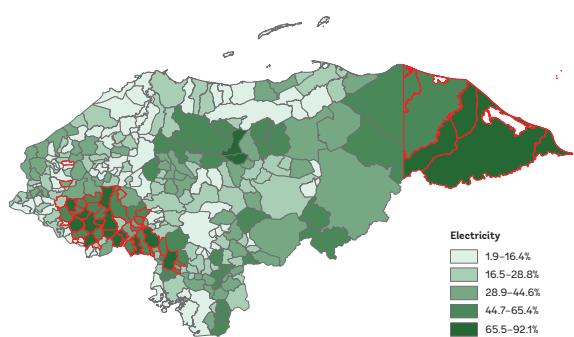
Notes

1. FDI and long term growth are usually positively correlated. There is micro level evidence pointing to positive externalities emanating from foreign owned companies to local industries in host countries. Carkovic and Levine (2005) have shown that FDI does not exhibit a strong independent influence on economic growth.
2. Historically sources of economic growth have shifted between consumption-led and investment-led. Prior to the 1990s, growth was mostly led by consumption. At the beginning of the 1990s through to 2009, there was a market shift towards investment. Indeed, over the 1990s and the 2000–08 period, investment growth contributed on average 47 percent of observed GDP growth, up from only 3 percent in the 1980s, and about 26 percent in the 1970s. More recently, there has been a return towards consumption as the primary driver of growth, with remittances playing an important role supporting consumption.
3. This analysis is confirmed by Honduras' relatively high ICOR (Incremental Capital-Output Ratio), which is an index that measures the effectiveness of investment: the higher the ICOR, the lower the productivity of investment. This analysis is also linked to the evidence of low productivity levels in Honduras, which are confirmed through other studies, including a recent IMF working paper (see Sosa et al. 2013).

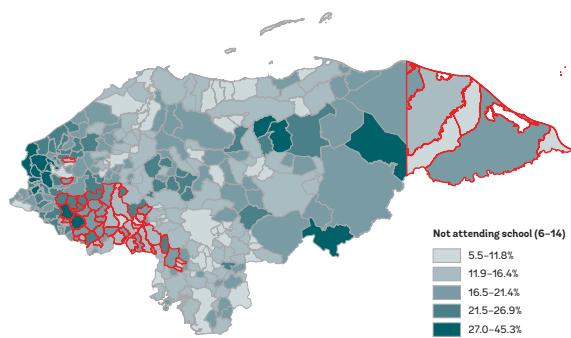
Appendix F

Maps of Access to Services, 2013

MAP F.1 Percentage of Households with Access to Electricity Networks in Honduras, 2013

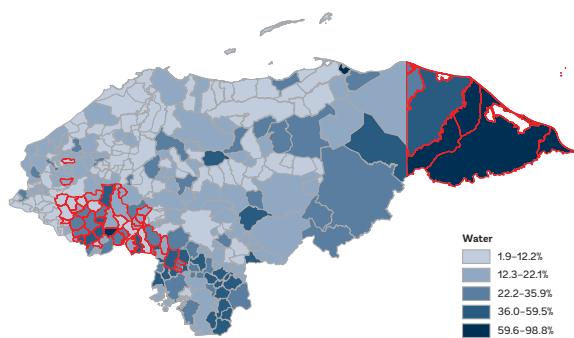


MAP F.3 Percentage of Children Aged 6–14 Years Not Attending School in Honduras, 2013



Source: World Bank estimates based on tabulations from the XVII Population and VI Housing Census (2013), provided by the Honduran authorities.

MAP F.2 Percentage of Households without Access to Piped Water in Honduras, 2013



Appendix G

Gender Gap Regressions, 2003–13

TABLE G.1 Gender Gap Regressions, 2003–13

	2003			2013		
	(1)	(2)	(3)	(1)	(2)	(3)
Male	-0.105*** (0.0132)	0.103*** (0.0118)	0.193*** (0.0129)	-0.262*** (0.0241)	-0.0371* (0.0222)	0.121*** (0.0244)
Years of education		0.0977*** (0.00138)	0.0715*** (0.00156)		0.0972*** (0.00257)	0.0600*** (0.00292)
Age		0.0481*** (0.00206)	0.0417*** (0.00199)		0.0370*** (0.00384)	0.0475*** (0.00375)
Age squared		-0.000441*** (2.59e-05)	-0.000407*** (2.44e-05)		-0.000379*** (4.63e-05)	-0.000464*** (4.46e-05)
Urban setting		0.112*** (0.0143)	0.0420*** (0.0149)		0.210*** (0.0275)	-0.0362 (0.0265)
Formal sector			-0.355*** (0.0150)			-0.290*** (0.0278)
Total hours worked			-0.0147*** (0.000338)			-0.0164*** (0.000584)
Constant	2.724*** (0.0105)	1.054*** (0.0406)	2.483*** (0.0558)	2.653*** (0.0177)	1.157*** (0.0819)	1.578*** (0.108)
Regional indicators	✓	✓	✓	✓	✓	✓
Type of employment	✓	✓	✓	✓	✓	✓
Sector of activity (1 digit ISIC)	✓	✓	✓	✓	✓	✓
Observations	29,166	28,720	27,714	10,915	10,870	10,588
R-squared	0.002	0.266	0.381	0.010	0.209	0.350

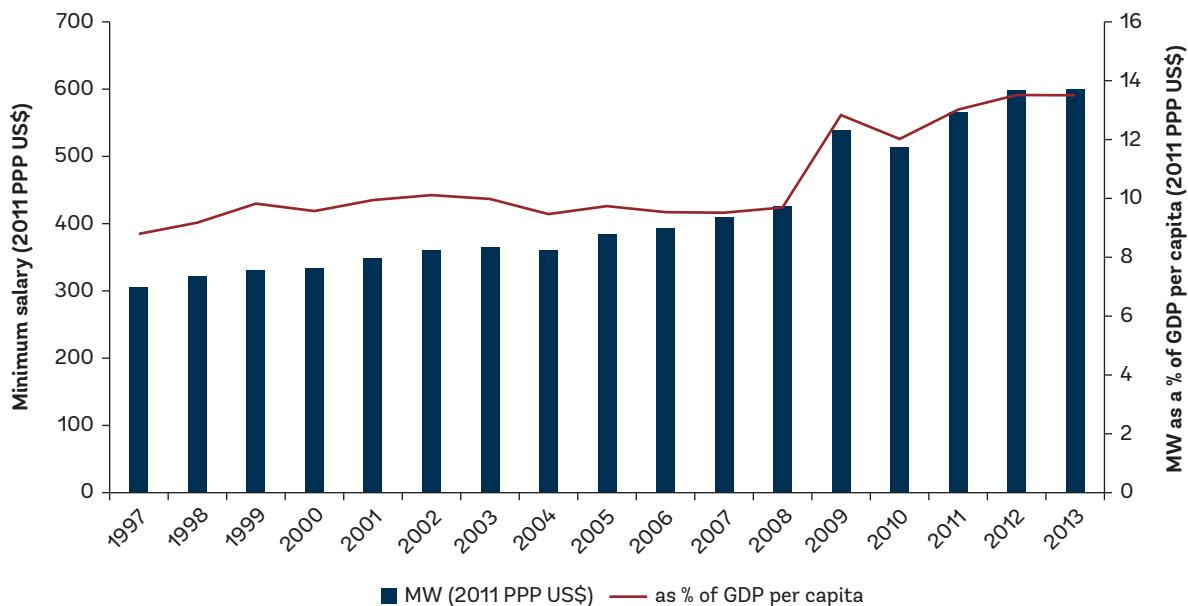
Source: Own calculations using SEDLAC (CEDLAS and the World Bank).

Note: The dependent variable is the log of real wage per hour. Column (1) controls for gender. Column (2) controls for gender, years of schooling, age, age-squared, urban setting and region. Column (3) controls for the previous variables plus type of employment (employer, salaried workers and self-employed), formality, total hours worked per week, and industry of employment. *** $p<0.01$, ** $p<0.05$, * $p<0.1$.

Appendix H

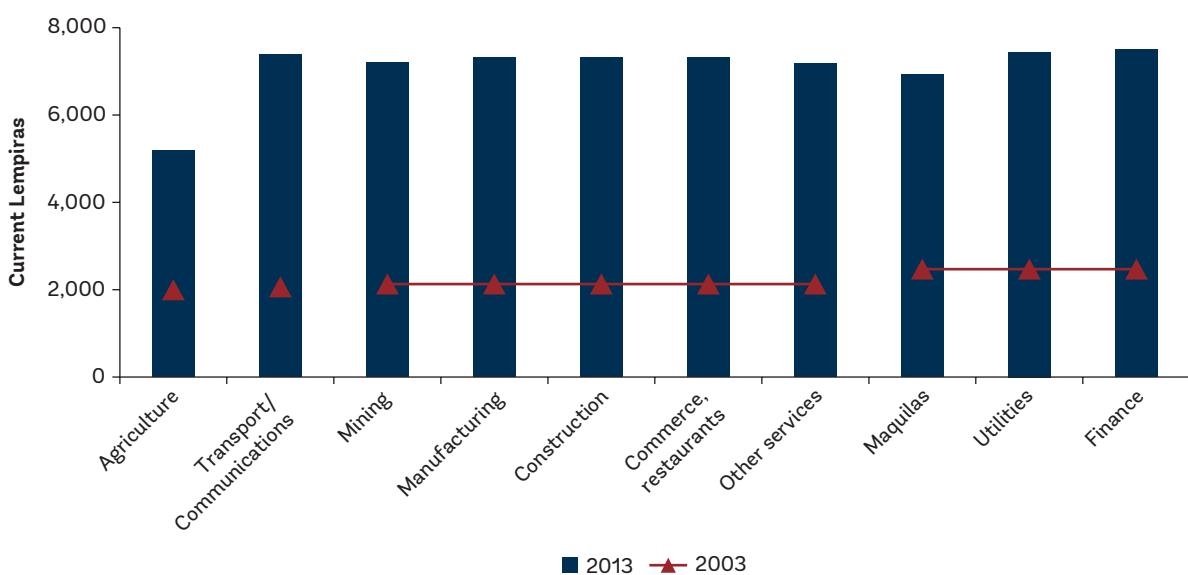
Minimum Wage

FIGURE H.1 Honduran Minimum Salaries Were Already High before the 2009 Increase
(Minimum salaries as a share of GDP per capita 2011 PPP, 1997–2013)



Source: World Bank staff tabulations using Honduran Government data for minimum salary and the World Development Indicators for GDP per capita.
Note: The minimum salary is calculated as an unweighted average of minimum salaries across sectors and firm sizes.

FIGURE H.2 Minimum Salaries for Agricultural Workers Have Fallen Behind
(Minimum salary for large firms by sector, 2003 and 2013)



Source: World Bank staff tabulations using Honduran Government data.
Note: Minimum salaries of large firms were used for this analysis. Sectors with the same minimum salary in 2013 are connected by lines.

Appendix I

Gender Labor Market Indicators, 2003–13

TABLE I.1 Gender Labor Market Indicators, by Type of Employment

		2003			2013		
		Mean hourly wage	Median hourly wage	Share of employment (%)	Mean hourly wage	Median hourly wage	Share of employment (%)
Overall							
Male	All	2.34	1.26	83.5	2.23	1.30	76.6
Female	All	2.37	1.36	93.5	2.48	1.46	86.8
Gender gap	All	-0.01	-0.07	-0.1	-0.10	-0.11	-0.1
Type of employment							
Male	Other	4.81	2.18	8.7	3.69	1.17	11.6
	Public sector	4.63	3.24	3.3	4.53	3.37	2.8
	Self-employed	2.13	1.10	19.7	1.65	0.84	18.9
	Waged in large firm	2.31	1.58	15.9	2.50	2.07	13.7
	Waged in small firm	1.09	0.83	17.1	1.31	0.98	16.1
Female	Other	5.51	2.46	1	4.60	1.83	2.4
	Public sector	4.53	3.65	4	4.71	3.87	3.8
	Self-employed	2.18	1.11	15	2.08	1.05	17.1
	Waged in large firm	2.29	1.59	9	2.60	2.20	7.7
	Waged in small firm	0.91	0.59	6	1.30	0.95	6.0
Gender gap	Other	-0.1	-0.1	0.1	-0.2	-0.4	0.1
	Public sector	0.0	-0.1	0.0	0.0	-0.1	0.0
	Self-employed	0.0	0.0	0.0	-0.2	-0.2	0.0
	Waged in large firm	0.0	0.0	0.1	0.0	-0.1	0.1
	Waged in small firm	0.2	0.4	0.1	0.0	0.0	0.1

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Large firms are defined as those employing more than five workers.

TABLE I.2 Gender Labor Market Indicators, by Type of Sector

		2003			2008			2013		
		Mean hourly wage	Median hourly wage	Share of employment (%)	Mean hourly wage	Median hourly wage	Share of employment (%)	Mean hourly wage	Median hourly wage	Share of employment (%)
Type of sector										
Male	Construction & utilities	2.31	1.50	9.7	2.80	1.71	10.8	2.24	1.52	9.3
	Domestic services	1.03	0.90	0.3	1.78	1.20	0.4	1.60	1.36	0.4
	Industry	2.16	1.55	9.1	2.83	1.93	7.4	2.32	1.82	6.3
	Primary	1.61	0.81	29.5	1.88	0.81	28.2	1.55	0.73	29.9
	Commerce	3.41	1.81	9.7	3.07	1.83	9.1	2.73	1.83	10.1
	Services	4.07	2.48	6.6	4.52	2.75	7.5	4.02	2.49	6.8
Female	Construction & utilities	4.02	2.58	0.6	4.67	2.31	0.5	3.41	2.66	0.6
	Domestic services	0.64	0.48	3.2	1.07	0.90	3.3	1.17	0.84	3.1
	Industry	1.69	1.32	9.1	2.14	1.54	7.8	1.80	1.38	6.8
	Primary	2.15	0.91	2.5	2.71	0.88	3.5	3.64	0.96	3.5
	Commerce	2.62	1.36	11.7	2.05	1.39	12.2	2.07	1.33	14.3
	Services	3.47	2.46	7.9	4.25	2.89	9.4	3.56	2.64	8.8
Gender gap	Construction & utilities	-0.4	-0.4	0.1	-0.4	-0.3	0.1	-0.3	-0.43	0.1
	Domestic services	0.6	0.9	0.0	0.7	0.3	0.0	0.4	0.61	0.0
	Industry	0.3	0.2	0.0	0.3	0.2	0.0	0.3	0.31	0.0
	Primary	-0.2	-0.1	0.3	-0.3	-0.1	0.2	-0.6	-0.24	0.3
	Commerce	0.3	0.3	0.0	0.5	0.3	0.0	0.3	0.38	0.0
	Services	0.2	0.0	0.0	0.1	0.0	0.0	0.1	-0.06	0.0

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

TABLE I.3 Gender Labor Market Indicators, by Type of Category

		2008			2013		
		Mean hourly wage	Median hourly wage	Share of employment (%)	Mean hourly wage	Median hourly wage	Share of employment (%)
Type of category							
Male	Formal	3.26	2.25	55.3	3.27	2.41	53.1
	Informal	2.57	1.27	65.9	2.02	1.05	63.6
Female	Formal	3.28	2.25	44.7	3.55	2.74	46.9
	Informal	2.48	1.28	34.1	2.13	1.11	36.4
Gender gap	Formal	-0.01	0.00	0.1	-0.1	-0.1	0.1
	Informal	0.04	-0.01	0.3	0.0	0.0	0.3

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Appendix J

Employment, 2003–13

TABLE J.1 Employment Levels, by Type, Sector, and Category

	2003	2013
Type of employment (in % of total)		
Self employed	34.7	35.9
Waged in large firm	25.2	21.5
Waged in public sector	7.1	6.5
Waged in small firm	22.7	22.1
Others	10.3	14.1
Type of sector (in % of total)		
Construction & utilities	10.3	9.9
Industry	18.1	13.1
Primary	32.0	33.5
Retail	21.5	24.4
Services	14.5	15.6
Domestic services	3.5	3.5
Type of category (in % of total)		
Formal		17.4
Informal		82.6

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Formality is defined as workers that contribute to the social security system; the question for social security starts in 2005, thus no data is presented for 2003. Wage refers to hourly labor income (2005 PPP dollars).

TABLE J.2 Share of Self-Employed, by Sector and Skill Level

Sector	Skill level	2003	2008	2013
Commerce	Unskilled	5.9	4.6	5.0
	Low-skilled	4.4	4.3	5.7
	Skilled	1.3	1.3	1.7
	All self-employed	11.7	10.2	12.4
	Construction & utilities	Unskilled	1.1	0.8
		Low-skilled	1.2	1.4
		Skilled	0.3	0.3
	Industry	All self-employed	2.7	2.5
		Unskilled	3.4	2.4
		Low-skilled	2.2	1.9
Primary	Skilled	0.3	0.4	0.5
	All self-employed	5.9	4.6	5.4
	Services	Unskilled	10.2	8.3
		Low-skilled	2.5	2.4
		Skilled	0.1	0.1
	Services (incl. domestic)	All self-employed	12.8	10.7
		Unskilled	1.8	1.4
		Low-skilled	0.8	1.1
		Skilled	0.3	0.4
All	All self-employed	3.0	3.0	3.8
	Unskilled	22.5	17.5	19.1
	Low-skilled	11.3	11.0	15.2
	Skilled	2.3	2.5	3.4
	All self-employed	36.0	30.9	37.7

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Appendix K

Wages, by Skill Level, 2003–13

TABLE K.1 Wages, by Skill Level and Type of Employment

		2003		2013	
		Mean hourly wage	Median hourly wage	Mean hourly wage	Median hourly wage
Overall					
Unskilled	All	1.59	0.93	1.55	0.90
Low-skilled	All	2.06	1.32	2.15	1.33
Skilled	All	4.90	3.22	3.89	2.57
Type of employment					
Unskilled	Public sector	1.72	1.44	2.26	1.83
	Self-employed	1.67	0.90	1.45	0.77
	Waged in large firm	1.39	1.22	1.77	1.54
	Waged in small firm	0.91	0.71	1.16	0.90
Low-skilled	Public sector	2.43	2.07	2.74	2.56
	Self-employed	2.58	1.42	2.10	1.09
	Waged in large firm	1.73	1.48	2.07	1.87
	Waged in small firm	1.04	0.81	1.31	1.00
Skilled	Public sector	5.54	4.32	5.34	4.39
	Self-employed	4.16	2.36	2.66	1.46
	Waged in large firm	4.04	2.72	3.32	2.57
	Waged in small firm	2.59	1.63	1.87	1.46

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Employers and unpaid family workers are excluded from this table. Large firms are defined as those employing more than five workers.

TABLE K.2 Wages, by Skill Level and Type of Sector and Category

		2003		2013	
		Mean hourly wage	Median hourly wage	Mean hourly wage	Median hourly wage
Type of sector					
Unskilled	Construction & utilities	1.73	1.26	1.85	1.28
	Domestic services	0.65	0.47	0.98	0.82
	Industry	1.39	1.06	1.60	1.12
	Primary	1.45	0.78	1.35	0.70
	Retail	2.31	1.30	1.92	1.17
	Services	1.59	1.07	1.96	1.40
Low-skilled	Construction & utilities	2.14	1.55	2.03	1.48
	Domestic services	0.66	0.53	1.33	0.93
	Industry	1.79	1.45	1.88	1.63
	Primary	1.77	0.92	2.18	0.80
	Retail	2.82	1.48	2.23	1.46
	Services	2.21	1.63	2.81	1.95
Skilled	Construction & utilities	5.20	3.22	3.75	2.44
	Domestic services	1.35	1.04	1.27	0.73
	Industry	3.59	2.36	3.19	2.16
	Primary	7.69	2.81	3.70	1.64
	Retail	4.57	2.36	3.02	2.13
	Services	5.30	3.91	4.80	3.66
Type of category					
Unskilled	Formal			1.94	1.76
	Informal			1.53	0.86
Low-skilled	Formal			2.31	2.13
	Informal			2.12	1.16
Skilled	Formal			4.23	3.16
	Informal			3.52	1.91

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Formality is defined as workers that contribute to the social security system; the question for social security starts in 2005, thus no data is presented for 2003. Wage refers to hourly total labor income (2005 PPP dollars). Employers and unpaid family workers are excluded from this table.

Appendix L

Labor Market Indicators for Agriculture, 2003–13

TABLE L.1 Agricultural Wages, by Skill Level and Type of Employment

	2003		2013	
	Mean hourly wage	Median hourly wage	Mean hourly wage	Median hourly wage
Unskilled				
Employer	3.56	1.23	2.12	0.65
Salaried worker	0.93	0.79	1.24	0.95
Self-employed	1.28	0.67	0.98	0.50
Low skilled				
Employer	3.99	1.62	4.29	0.75
Salaried worker	1.07	0.89	1.22	1.01
Self-employed	1.66	0.78	1.82	0.47
Skilled				
Employer	15.29	5.07	5.29	1.80
Salaried worker	3.21	2.27	2.80	1.68
Self-employed	2.26	0.88	2.90	0.31

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

TABLE L.2 Share of Employment in Agriculture, by Skill Level

	2003	2008	2013
Unskilled	71.34	65.38	56.82
Low skilled	26.98	32.24	39.81
Skilled	1.68	2.37	3.37

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Appendix M

Wages and Employment, by Formality Status

TABLE M.1 Wages, by Type of Category, 2008–13

	2008				2013			
	Formal		Informal		Formal		Informal	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
All	3.27	2.25	2.54	1.28	3.40	2.53	2.06	1.08
Gender								
Female	3.28	2.25	2.48	1.28	3.55	2.74	2.13	1.11
Male	3.26	2.25	2.57	1.27	3.27	2.41	2.02	1.05
Region								
Rural	2.97	2.21	1.94	1.00	2.88	2.28	1.76	0.89
Urban	3.35	2.28	3.24	1.60	3.53	2.57	2.45	1.37
Type								
Employer	7.66	6.02	4.40	1.84	8.00	6.81	3.66	1.22
Salaried worker	3.23	2.24	2.22	1.29	3.35	2.53	1.57	1.15
Self-employed	3.26	1.60	2.07	1.09	4.54	2.25	1.94	0.97
Industry								
Hotels and restaurants	2.29	1.75	2.33	1.56	2.59	2.41	2.98	1.40
Mining and quarrying	3.25	1.73	1.96	1.48	0.47	0.47	1.33	0.81
Public administration	4.60	3.28	4.14	2.75	3.87	3.11	2.96	2.06
Transport, storage and communications	3.37	2.57	4.20	1.83	3.37	2.56	2.15	1.63
Activities of private households as employers	1.67	1.48	1.13	0.92	1.71	1.75	1.21	0.85
Agriculture, hunting and forestry	2.39	1.85	1.95	0.77	2.22	1.96	1.75	0.72
Construction	4.02	2.66	2.14	1.58	4.75	3.11	1.99	1.33
Education	5.62	4.81	5.45	4.26	5.04	4.40	3.35	2.34
Electricity, gas and water supply	3.53	2.89	4.22	2.89	3.79	2.93	3.04	2.10
Extraterritorial organizations and bodies	6.80	4.25	13.13	9.63	5.34	5.12	6.27	7.32
Financial intermediation	3.21	2.44	5.20	2.77	3.72	2.93	2.83	2.30
Fishing	1.89	1.60	2.76	1.90	1.95	1.94	1.74	1.25
Health and social work	4.27	2.89	4.85	3.21	5.44	2.99	3.80	2.17
Manufacturing	2.54	1.99	2.47	1.47	2.35	2.00	1.91	1.28
Other community, social and personal service activities	3.69	2.21	2.90	1.42	3.13	2.38	2.71	1.39
Real estate, renting and business activities	2.53	1.61	5.17	1.98	2.60	2.13	4.36	1.95
Wholesale and retail trade	2.69	2.00	2.52	1.51	2.81	2.42	2.14	1.29
Skills								
Unskilled	1.89	1.60	1.69	0.95	1.94	1.76	1.53	0.86
Low skilled	2.17	1.85	2.37	1.31	2.31	2.13	2.12	1.16
Skilled	4.40	3.21	5.32	3.04	4.23	3.16	3.52	1.91

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Formality is defined as workers that contribute to the social security system; the question for social security starts in 2005, thus no data is presented for 2003. Wage refers to hourly total labor income (2005 PPP dollars). Unpaid workers are excluded from this table.

TABLE M.2 Share of Employment, 2008–13

	2008		2013	
	Formal (%)	Informal (%)	Formal (%)	Informal (%)
All				
Gender				
Female	44.7	34.8	46.4	35.4
Male	55.3	65.2	53.6	64.6
Region				
Rural	20.1	56.0	20.9	57.2
Urban	79.9	44.0	79.1	42.8
Type				
Employer	1.0	15.4	0.8	14.2
Salaried worker	98.3	40.6	98.5	35.0
Self-employed	0.5	32.9	0.5	38.2
Not salaried	0.2	11.1	0.1	12.5
Unemployed	0.0	0.0	0.0	0.0
Industry				
Agriculture, hunting and forestry	2.5	36.9	2.9	38.6
Fishing	1.0	0.4	1.2	0.7
Mining and quarrying	0.1	0.3	0.0	0.3
Manufacturing	33.8	11.3	23.4	10.9
Electricity, gas and water supply	1.2	0.2	2.0	0.2
Construction	2.0	8.4	1.6	6.6
Wholesale and retail trade	15.1	18.2	18.1	21.2
Hotels and restaurants	3.7	3.5	3.1	4.0
Transport, storage and communications	3.8	3.8	4.7	3.4
Financial intermediation	4.6	0.5	5.2	0.2
Real estate, renting and business activities	5.1	2.0	4.7	1.7
Public administration	8.9	1.5	9.0	0.7
Education	11.3	3.1	16.2	1.3
Health and social work	4.4	1.4	5.9	1.0
Other community, social and personal service activities	1.8	4.0	1.5	5.1
Activities of private households as employers	0.5	4.3	0.5	4.2
Extraterritorial organizations and bodies	0.2	0.0	0.1	0.0

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Formality is defined as workers that contribute to the social security system; the question for social security starts in 2005, thus no data is presented for 2003. Wage refers to hourly total labor income (2005 PPP dollars). Unpaid workers are excluded from this table.

TABLE M.3 Share of Employment, by Skill Level, 2008–13

	2008		2013	
	Formal (%)	Informal (%)	Formal (%)	Informal (%)
Skills				
Unskilled				
Unskilled	10.5	42.3	6.6	37.8
Low skilled	38.5	42.4	35.4	48.9
Skilled	51.0	15.3	58.0	13.3

Source: World Bank estimates using SEDLAC (CEDLAS and the World Bank) and EPHPM.

Note: Formality is defined as workers that contribute to the social security system; the question for social security starts in 2005, thus no data is presented for 2003. Wage refers to hourly total labor income (2005 PPP dollars). Unpaid workers are excluded from this table.

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