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HONDURAS INCLUSIVE GROWTH DIAGNOSTIC

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Honduras Inclusive Growth Diagnostic

Center for Economics and Market Development, Bureau for Development, Democracy, and Innovation

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ACRONYMS

COVID-19	-	coronavirus disease 2019
ECLAC	-	Economic Commission for Latin America and the Caribbean
EPHPM	-	Encuesta Permanente de Hogares de Propósitos Múltiples
FDI	-	foreign direct investment
GDP	-	gross domestic product
GOH	-	Government of Honduras
HRV	-	Hausmann, Rodrik and Velasco
ICT	-	information and communications technology
IDB	-	Inter-American Development Bank
IGD	-	inclusive growth diagnostic
IIES	-	Instituto de Investigaciones Económicas y Sociales
ILO	-	International Labour Organization
IMF	-	International Monetary Fund
INFOP	-	Instituto Nacional de Formación Profesional
LAC	-	Latin America and the Caribbean
LAPOP	-	Latin American Public Opinion Project
MCC	-	Millennium Challenge Organization
MW	-	megawatts
OECD	-	Organisation for Economic Cooperation and Development
PISA	-	Program for International Student Assessment
PPP	-	purchasing power parity
R&D	-	research and development
SECMCA	-	Consejo Monetario Centroamericano
SME	-	Small and medium enterprises
TVET	-	Technical and vocational training
UN	-	United Nations
UNAH	-	Universidad Nacional Autónoma de Honduras
UNDP	-	United Nations Development Program
USAID	-	U.S. Agency for International Development
WAP	-	working age population
WEF	-	World Economic Forum
WHO	-	World Health Organization
ZEDE	-	Zone for Employment and Economic Development

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I EXECUTIVE SUMMARY

Over the past 20 years, Honduras has had decent growth driven primarily by private household consumption and remittances. The country's economy has been resilient in response to COVID-19 as remittances and exports have rebounded and firms and workers are returning to economic activities. Nonetheless, there have been varying levels of private investment, the rate of growth declined prior to the pandemic, and Honduras has extremely high levels of poverty and inequality. This lack of economic opportunity has resulted in a large informal sector, a deterioration in the quality of jobs, and continued immigration in search of better opportunities.

The purpose of the Honduras inclusive growth diagnostic (IGD) is to identify the constraints that deter households and firms from making investments and taking risks that would significantly increase their incomes. To achieve this, we have applied the growth diagnostic methodology (Annex I) to national and international datasets and have consulted local stakeholders. Our findings suggest investment and inclusive growth are constrained by low returns to economic activities due to (1) low human capital, (2) high administrative costs, and (3) crime and security.

To uncover the underlying “syndrome” causing these constraints, we held two workshops with the private sector, academia, subject matter experts, and USG personnel, among others. The consistent syndrome reported across each of these constraints is limited public service delivery. This is evident in a lack of transparency and accountability, limited political will, and poor public and private sector coordination. Although the growth diagnostic methodology does not prescribe specific interventions in response to our diagnosis, we are reporting the recommendations that were provided during the workshops to inform decision makers and the national dialogue for reform.

I.1 RESULTS AND CONCLUSIONS

I.1.1 HUMAN CAPITAL IS A BINDING CONSTRAINT TO GROWTH

Honduras has low levels of educational attainment, particularly in rural areas, with economic insecurity being the main reason children drop out of school. Enrollment begins to drop precipitously by age 12, with significant disparities between urban and rural populations, and poor and non-poor households. By age 16, just 37 percent of children in rural areas are enrolled in school compared to 78 percent of children in urban areas. According to the World Bank, Honduras has the highest percentage (53 percent) of students of any country in Central America who cite economic insecurity as the main reason they leave school.

Honduras has higher monetary returns to education than any comparator country, although women experience substantially lower returns to education than men. Workers earn over 12 percentage points in increased wages per additional year of schooling, providing evidence of a low supply of educated workers relative to market demand. However, the gap in returns to education for men and women has widened between 2016 and 2019, suggesting the barriers to women's full participation in the labor force and access to high quality jobs has worsened.

Despite large public and private investments, education struggles with infrastructure, quality, and training. The low returns on public investment may in part be due to the large wage bill, which accounted for around 90 percent of education spending from 2007 to 2017 - higher than any reporting comparator country. Firms are making investments to improve the skill level of workers. Between 47 percent and 76 percent of firms report providing training to employees.

Labor force participation is low, even among individuals with higher levels of education, and underemployment rates are climbing. This challenge is particularly salient among women. In 2020, just 47.3 percent of working-age women participated in the labor force, compared to 80.7 percent of men. Jobs are frequently low quality, and underemployment is a rising challenge. As of 2020, 71 percent of Hondurans report that they are underemployed, including workers making less than the minimum wage.

Low educational attainment, poor labor market conditions, and high levels of migration have created a vicious cycle wherein the labor market cannot absorb the glut of low to medium-skilled workers, creating incentives to migrate. This migration in turn drains vital human capital while raising workers' reservation wages, reducing competitiveness, and stymying growth.

I.1.2 CRIME AND SECURITY IS A BINDING CONSTRAINT TO GROWTH

Both violent and non-violent crime is rampant in Honduras. Though down from a peak high of almost 84 intentional homicides per 100,000 people in 2011, the country's murder rate remains fifth highest worldwide. Honduras also faces challenges related to broader types of crime, including robbery, burglary, assault, blackmail, fraud, extortion, and violent threats. Approximately 1 in 5 Hondurans are victims of crime annually, a rate that has been trending upward since 2010.

Honduran firms bear significant security costs and losses due to theft and vandalism.

According to the World Bank, the combined costs of both private security and losses suffered due to theft and vandalism is 11.7 percent of total sales. This is higher both by component and in sum than in all comparator countries and the regional average, suggesting that Honduran firms pay a large shadow price for the high levels of crime and poor security environment in which they operate.

The aggregate impact of crime and insecurity also poses a significant cost to gross domestic product (GDP) growth rates and levels. According to 2019 data from the Institute of Economics and Peace, the impact of crime and violence levies a cost on the Honduran economy equivalent to 13 percent of GDP. This is likely an underestimation of the true economic cost of crime in Honduras given that it focuses on only violence and conflict and not on other types of non-violent crime.

High levels of crime and security force Honduran firms to utilize private security to protect their businesses. The number of private security personnel employed is high, particularly compared with the total number of police officers. Honduras has one of the highest ratios of private security to police in the world, with 7 private security guards employed for every police officer. This use of private security has also expanded over time, growing tenfold between 2007 and 2017.

Firms in the service sector are more heavily impacted by crime than manufacturing firms, suggesting actors less impacted by crime and security are more likely to survive and thrive. They employ private security, experience greater losses due to theft and vandalism, and identify crime, theft, and disorder as a major constraint at a significantly higher rate, and there is a similarly large gap in performance: lower annual sales, employment, and labor productivity growth.

I.1.3 A BURDENSOME REGULATORY ENVIRONMENT IS A BINDING CONSTRAINT TO GROWTH

Many interactions businesses have with the government are time consuming, expensive, and complicated. Firms must interact with the government to receive the permits and licenses required to start a business, to pay taxes, and interact with the courts to enforce

contracts and resolve insolvency. Across a variety of measures of cost, including time and money, these interactions are often burdensome to firms and are among the worst relative to comparator countries.

Challenges with trade and customs regulations appear to be centered around issues of transparency and accountability. This lack of transparency, combined with frequent policy changes, contributes to an overall environment of policy uncertainty. Honduras also performs poorly on “governance and impartiality”, which refers to inadequate public service delivery issues around ethics, transparency, and accountability of customs officials.

Informal employment is widespread and occurs at a greater rate than comparator countries. Most firms compete directly against unregistered or informal firms, and nearly one-half identify competitors in the informal sector as a “major constraint” to doing business. Burdensome regulatory requirements likely disincentivize formalization, particularly among small firms that may lack the administrative capacity to comply with Honduras’ complex regulatory framework.

Firms who believe administrative and regulatory burdens are a major obstacle employ fewer workers. The average number of employees at firms that believe regulatory burdens are a serious obstacle has also shrunk over time, suggesting that challenges around regulatory and administrative burdens may hamper firm performance (in terms of job creation) over the long-term.

The regulatory environment affects firms of different sizes in different ways. Honduran SMEs find the practices of the informal sector to be a significant obstacle and find tax administration issues less of a challenge. For large firms, tax administration is one of their greatest obstacles, with informality a more minor concern. Formal Honduran SMEs that must comply with government regulations and bear the significant time and monetary costs are competing with a large informal sector using their informality to competitive advantage by circumventing these same regulations.

1.1.4 A SYNDROME OF LIMITED PUBLIC SERVICE DELIVERY

Limited public service delivery is identified as the underlying cause for each of the binding constraints. The symptoms used to derive this syndrome were a lack of transparency and accountability, limited political will, and poor public and private sector coordination.

This syndrome is expressed in several ways for the human capital constraint. Poor coordination between the public and private sector results in a technical and vocational training system which fails to meet the needs of the private sector. Limited political will and accountability have manifested in repeatedly frustrated efforts to reform the education system. These poor outcomes, combined with a complex regulatory environment, contribute to underemployment and informality, increasing the economic insecurity that keeps many children out of school.

This syndrome also expresses itself via the poor regulatory environment. Administrative processes are redundant and lack systemization, and there is limited transparency around the regulatory process. Public officials often benefit from the opportunities and contradictions created by this environment, resulting in a lack of political will to tackle simplification and reform efforts, which in turn gives rise to the continued redundancy of administrative processes. The lack of accountability to follow through on commitments for reform further entrenches this constraint.

Limited public service delivery also manifests itself in the crime and security constraint. Lack of accountability and political will results in impunity and a weak judicial system. The police and judicial system are not effective at investigating and enforcing laws and prosecuting criminal activity.

For crimes that are reported, investigated, and solved, the perpetrators often face limited consequences and continue their criminal activities. There is a lack of collaboration between the public and private sector on these issues, often due to the perceived linkages of government actors to these problems.

All these factors contribute to an environment in which opportunities for economic advancement are limited, thereby increasing individuals' incentives to migrate. This migration, in turn, spurs a vicious cycle: high remittances increase the reservation wage, lowering competitiveness and labor force participation and disincentivizing public service delivery reforms. Thus, public service delivery continues to be poor, locking the economy in a low-level equilibrium.

1.2 RECOMMENDATIONS

Although the following recommendations reflect the summary feedback given at each workshop, it is important to acknowledge that finding tangible solutions to a syndrome as complex as inadequate public service delivery is beyond the scope of this analysis and would require additional research.

Any policy or programmatic decisions would be further informed by a political economy analysis to identify feasible solutions for addressing the underlying syndrome. Our analysis does not attempt to incorporate political economy considerations. That is, it identifies key constraints to growth, the underlying syndrome, and provides potential recommendations without assessing the political or practical feasibility of these reform efforts.

Public and private sector actors should improve engagement, coordination, and policy development. There is a critical need for increased engagement between the Government of Honduras (GOH), the private sector, and academia in designing policy and strategy. The valuable input of both public and private sectors will go hand-in-hand to develop solutions that address Honduras's constraints and pave the way for structural economic progress and growth.

The GOH and other actors should embrace digitization and improved utilization of e-platforms to reduce inconsistencies, streamlines services and increase transparency. One innovative solution that was proposed for addressing crime and security was encouraging the adoption of digital payments, which would decrease the exposure of service enterprises to extortion and theft due to the reduced handling of cash.

Honduras needs a new education policy and vocational training law. This should include a refreshed academic curriculum to address the wide gap in supply and demand for skills and provide quality educational services to children in harder to reach areas. The reforms should also create a certification system for distance learning platforms to improve and standardize educational quality.

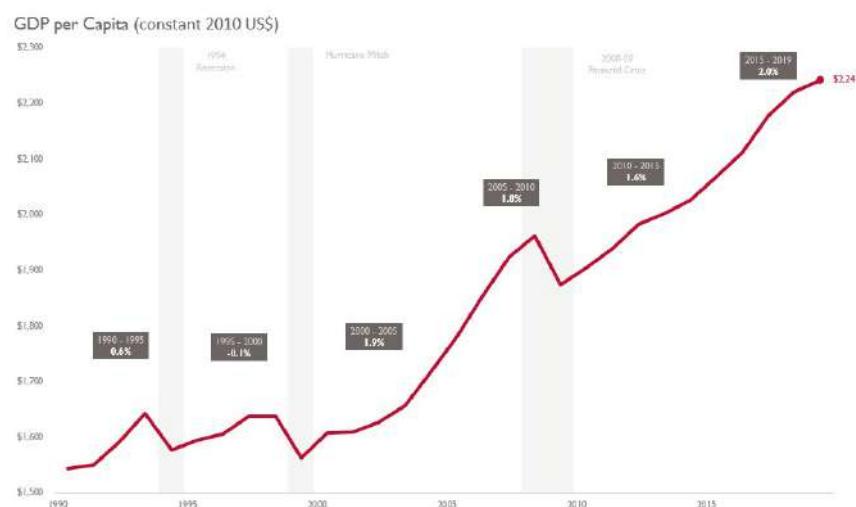
Honduras should increase transparency for government processes and transactions. This transparency, combined with broader adoption of anonymous reporting mechanisms (along the lines of the reporting mechanism for La Fuerza Nacional Anti Maras y Pandillas), could provide a means to improve public service delivery and citizen responsiveness. This is particularly salient to the judicial system, especially as it relates to reducing impunity and improving judicial system outcomes.

2 OVERVIEW AND BACKGROUND

2.1 ECONOMIC GROWTH HISTORY

Between 1990 and 1999, gross domestic product (GDP) per capita growth in Honduras was sluggish, averaging just 0.17 percent annually (Figure 2-1). During this period, the country experienced two setbacks, including an economic recession in 1994 and the fallout from Hurricane Mitch in 1999. In the eight years leading up to the global financial crisis, Honduras experienced 2.6 percent in annual GDP per capita growth. Since 2010, Honduras has averaged 1.8 percent in annual GDP per capita growth, although the rate of growth declined in 2018 and 2019.

Figure 2-1: Economic Growth in Honduras (1990 - 2019)



Source: Economic Commission for Latin America and the Caribbean (ECLAC)

Over the past 20-years, Honduras' growth in GDP per capita was around the middle point relative to the comparators and other countries in the region (Figure 2-2). However, Honduras remains one of the poorest countries in Latin America and the Caribbean (LAC) (Figure 2-3) with an income level of \$5,700 per capita at purchasing power parity (PPP). This is higher than only Haiti and Nicaragua.

Figure 2-2: Regional GDP Growth

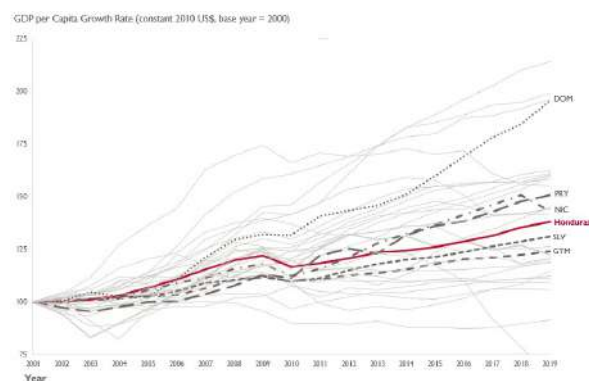
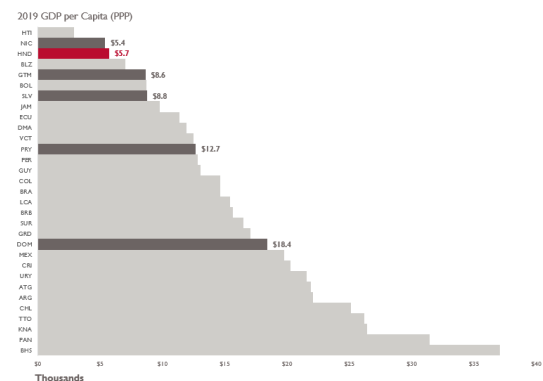


Figure 2-3: GDP per Capita, PPP (2019)

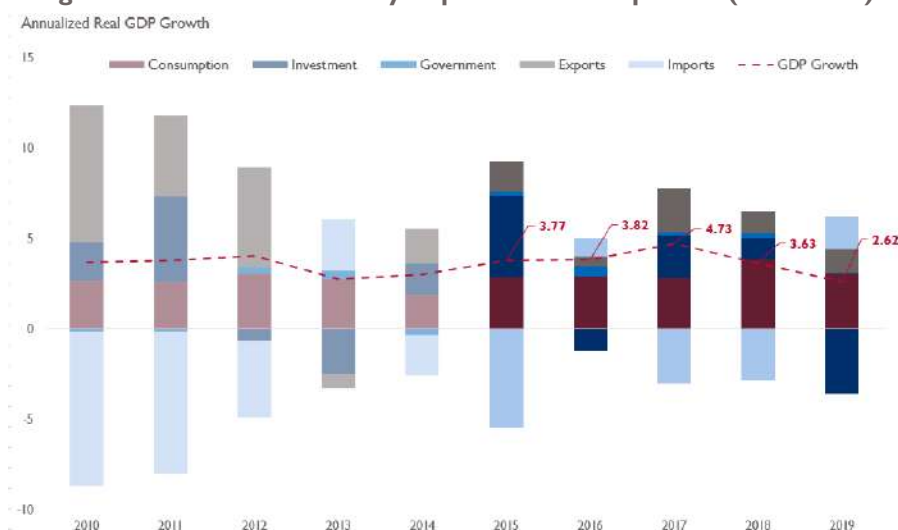


Source: Economic Commission for Latin America and the Caribbean

Decomposing Honduras's growth over time by expenditure components allows us to see what types of spending are driving growth and whether the relative share of these components is changing over time. Figure 2-4 shows that over the past 5 years private household consumption has consistently contributed to GDP growth at an average of almost 3 percent year-on-year (y-o-y), while exports

and private investment contributed an average of 1.41 percent and 0.64 percent to GDP growth, respectively. GDP growth declined from 4.7 percent in 2017 to 2.6 percent in 2019, which was primarily due to declining levels of y-o-y growth for private investment, and to a lesser extent a reduction in exports.

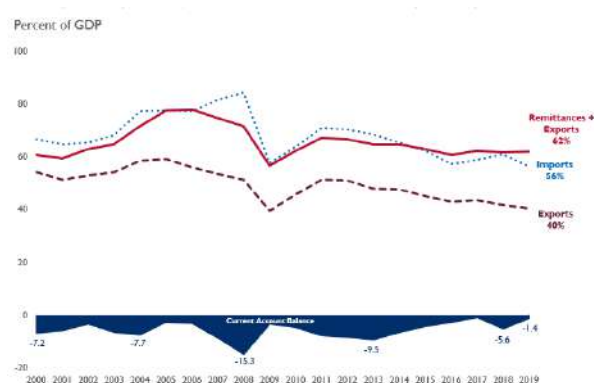
Figure 2-4: Honduras GDP by Expenditure Component (2010-2019)



Source: Banco Central de Honduras

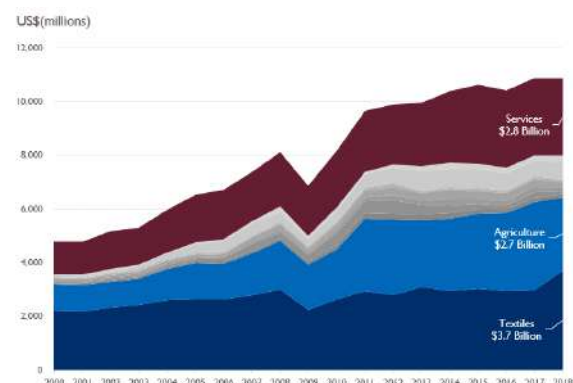
Exports declined from 54 percent of GDP in 2000 to 40 percent in 2019 (Figure 2-5). While this has put pressure on the current account deficit, it has been eased by increased remittances. Furthermore, the proportion of GDP coming from exports exceeds 4 out of 5 comparator countries. The export basket is mainly composed of textiles and agricultural goods like coffee, bananas and maquila (Figure 2-6). Diversifying into higher value-added exports would give Honduras greater potential to improve broad-based economic growth through higher productivity, efficient resource reallocation, and knowledge and technology spillovers (Anand et. al. 2012).

Figure 2-5: Trade and Current Account



Source: World Bank WDI; The Complexity Atlas; IMF

Figure 2-6: Trade by Sector (2000-18)



As a share of GDP, Honduras has one of largest remittance flows in the world, as well as a larger share than any of the comparator countries. From 2000 to 2019, remittances increased from 3 percent to 22 percent of GDP (Figure 2-7). After the 2008-09 financial crisis, remittances declined from 21 percent to 16 percent of GDP and remained at this level for 5-years before steadily increasing from 2014 to 2019. While remittances declined by 9.1 percent in 2020, they are expected to recover in 2021 (Figure 2-8).

Figure 2-7: Remittances (2019)

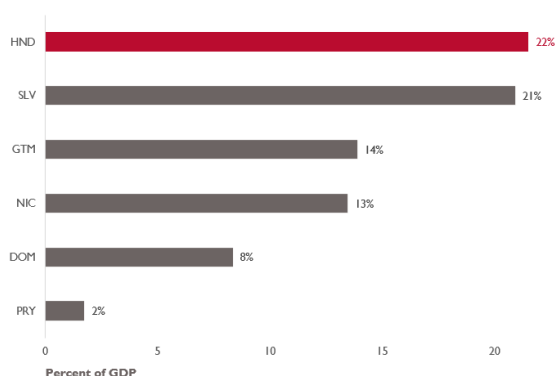
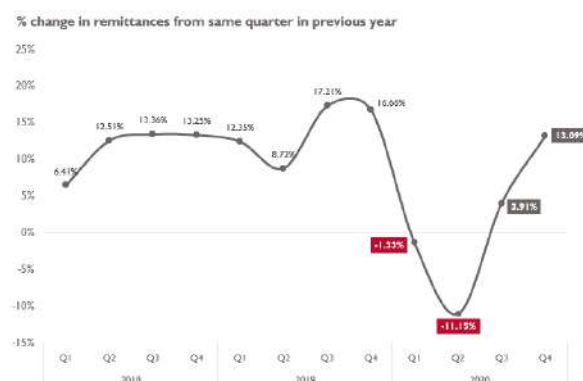


Figure 2-8: Remittances Growth by Quarter



Source: ECLAC; Banco Central de Honduras

Investments have hovered around 22-23 percent of GDP, while foreign direct investment (FDI) has not yet recovered from COVID-19. Investment's share of GDP has remained between 20 and 25 percent after declining from a peak value of over 35 percent in 2008. From 2016 to 2020, services accounted for the largest share of FDI, followed by maquila, transport, and utilities (Figure 2-9). FDI fell by 48 percent y-o-y in 2019 with the manufacturing sector and maquilas hit hardest. In 2020, FDI is expected to decline by 16 percent y-o-y, which is mainly driven by lower FDI for manufacturing (Figure 2-10).

Figure 2-9: FDI by Source

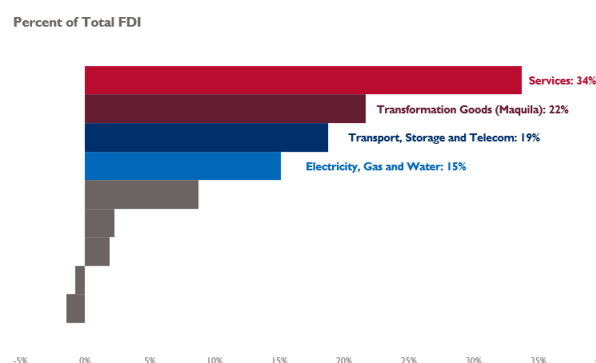
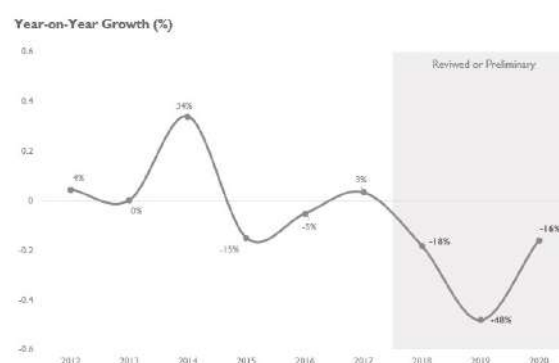


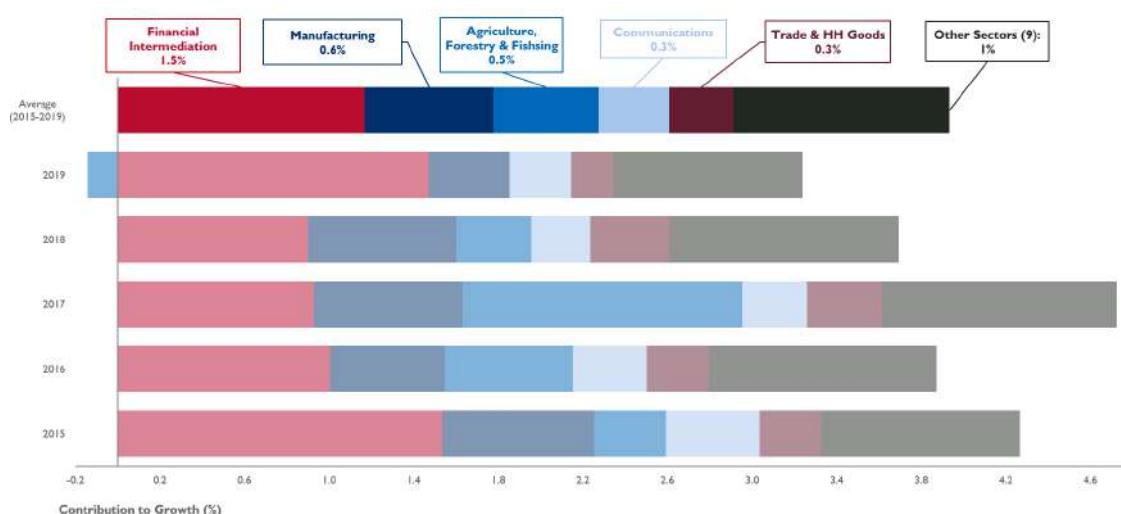
Figure 2-10: Growth in FDI by Quarter



Source: Banco Central de Honduras

Decomposing Honduras' growth over time by sectoral origins allows us to see what types of economic sectors are driving growth. Figure 2-11 demonstrates that over the past 5 years, financial intermediation has provided the largest share of growth at 1.5 percent, followed by manufacturing (0.6 percent) and agriculture, forestry, and fishing (0.5 percent). Although the financial intermediation and communication sectors collectively have accounted for 1.8 percent of average growth over the past 5-years, this growth has not resulted in significant job creation. For example, in 2019 less than 2 percent of employment was concentrated in these sectors. Since 1960, the share of GDP coming from agriculture has declined; that from services has increased; and manufacturing initially increased but has recently declined. This is similar to the growth trajectories of other countries.

Figure 2-11: GDP by Economic Sector (2015-2019)

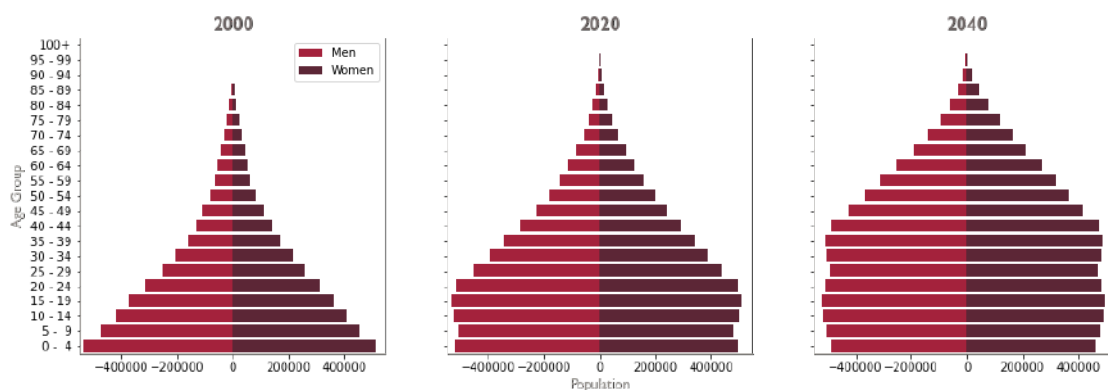


Source: Banco Central de Honduras

2.2 POPULATION, EMPLOYMENT, AND INCLUSIVITY

Figure 2-12 shows how Honduras' population trends have shifted in the past 20 years and provides projections for the next 20 years. In 2000, the country's demographic dividend or working-age population (WAP), which measures the share of the working age population between the ages of 15 and 64, was less than 60 percent. In 2020, the country's WAP was approximately 64 percent of the total population, which was higher than Guatemala (61 percent) but lower than the remaining comparator countries. By 2040, the WAP is expected to increase to 68 percent of the total population due to declining population growth and the reduced population share of children.

Figure 2-12: Population Pyramids



Source: Economic Commission for Latin America and the Caribbean

Hondurans are moving to urban areas for increased social and economic opportunities. Furthermore, while only 57 percent of the population lives in urban areas, the 2nd lowest percentage among the comparators countries, Honduras has one of highest recent growth rates for rural to urban migration (Figure 2-13). This trend will likely result in improved job opportunities and higher value addition per capita (Figure 2-14), as there are typically more formal job opportunities and a higher concentration of opportunities in the services sector. For example, 62 percent of urban jobs provide wages compared to only 42 percent in rural areas, and 67 percent of urban jobs are in the services sector compared to only 32 percent in rural areas (World Bank, 2019).

Figure 2-13 Urban Population

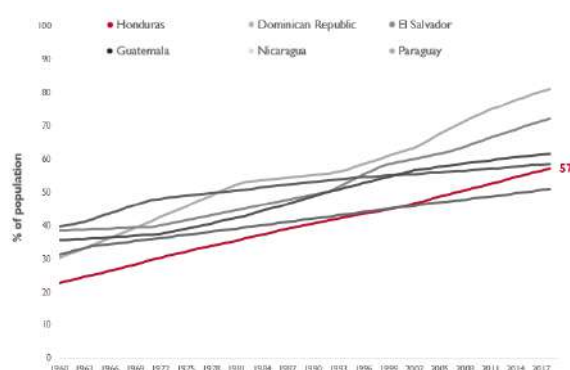
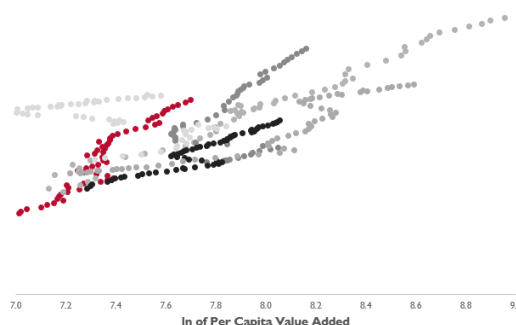


Figure 2-14: Urban Pop and Value Addition



Source: World Bank Jobs Group Demography Tool

Many Hondurans have also migrated primarily to the United States in search of better opportunities. Migration and attempted migration are mainly driven by a combination of factors including economic opportunity, family reunification, and an attempt to escape community violence. However, most emigrants cite economic reasons as a key motivator for emigration. This is understandable as the economic incentives to migrate are strong, with the estimated per capita income of Honduran migrants living in the United States anywhere from 3 to 9 times greater than what they would receive in Honduras. The people who have the greatest possibilities and means to migrate are those who come from the middle and upper strata of the income distribution. In 2017, this group accounted for over 50 percent of emigrant households (OIM 2020).

Several sources estimate the level of the country's out-migration. According to the World Bank, the share of the population living in the United States increased from 5.5 percent in 2006 to 7.5 percent in 2016 (2020). According to the United Nations, of the total annual flow of Honduras' international migrants, over 35 percent are under the age of 20, while an additional 53 percent are between the ages of 20 and 64 (2019). Moreover, in 2017, 13.7 percent of households had a member of their household who had emigrated, compared to 14.8 percent in 2013. This comes to approximately 282,000 families in which at least one person is living in another country, equivalent to about 424,000 migrants. Of this total, 59 percent are men, and the 41 percent are women (OIM 2020).

Figure 2-15: Employment by Sector

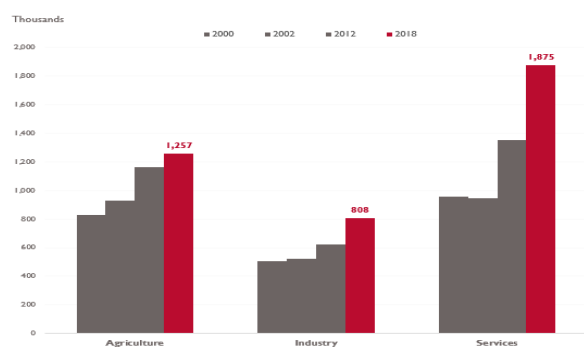
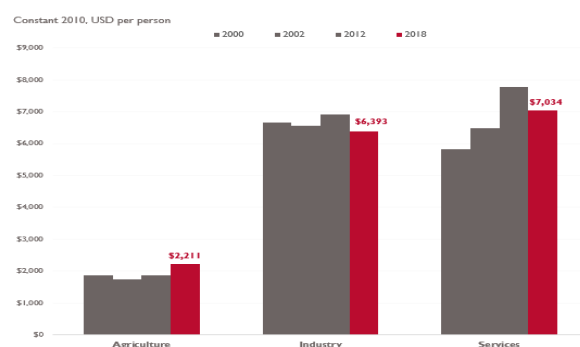


Figure 2-16: Value Addition per Worker



Source: World Bank Jobs Structure Tool; ECLAC - CELADE. Population Division of ECLAC

Given that they are sent directly to households and typically used to support household consumption, remittances have significant inclusivity implications. In the table below (Figure 2.1), we see that on average, women receive higher remittance levels than men. Further, those in urban areas receive more funds than those in rural areas. This may be due to the share of the population living in urban areas or it could be explained by the migration of people from rural to urban areas

(rather than abroad) as a first step in seeking to improve their economic conditions, as described in the human capital chapter.

Table 2-1: Average Remittances Received by Gender and Location, Monthly (in lempiras)

Men	464
Women	955
Rural	511
Urban	705

Source: Encuesta Permanente de Hogares de Propósitos Múltiples, 2019

For most Hondurans who choose not to migrate, there has been increased involvement in the domestic workforce. For instance, the labor force participation increased from 61 percent of Honduras' population in 2010 to 64 percent in 2020 (ECLAC). Although participation has increased, most jobs are concentrated in the informal sector, there are high levels of underemployment, and many job opportunities are in low-productivity activities.

The share of employment coming from services has increased and is expected to provide most of the employment over the next 3-5 years (Figure 1-15). According to the World Bank, the share of service sector jobs increased to 52 percent of all jobs in 2016, compared to 26 percent and 22 percent for agriculture and industry, respectively. Figure 1-16 shows that while jobs have moved into the services and industry sectors, average labor productivity declined in both sectors. This is primarily due to the fact that many of these jobs are in low-productivity activities (2019).

A high proportion (58 percent) of Honduran jobs are also informal, meaning many jobs have low productivity. Perhaps more worrisome is that the quality of employment has declined in recent years as visible and invisible underemployment has accounted for a larger share of the working population.¹ From 2003 to 2020, the percentage of people who were underemployed increased from 35 percent to 71 percent. When unemployment is added to this figure, the total number of people who are either underemployed or unemployed is 76.2 percent of the working population.

Figure 2-17: Employment by Department

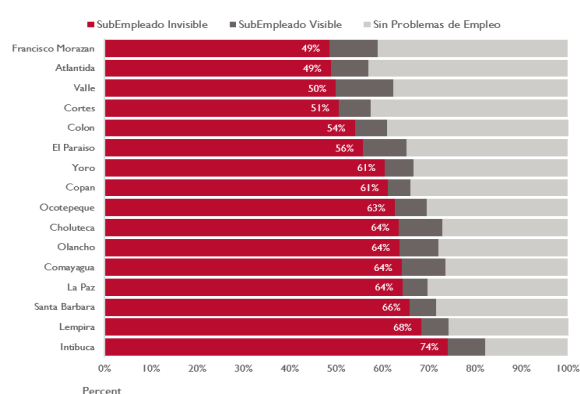
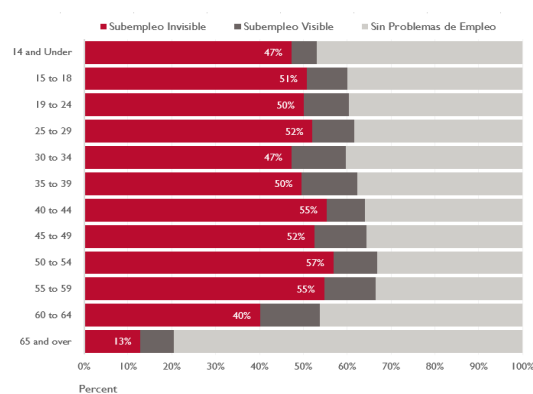


Figure 2-18: Employment Level by Age



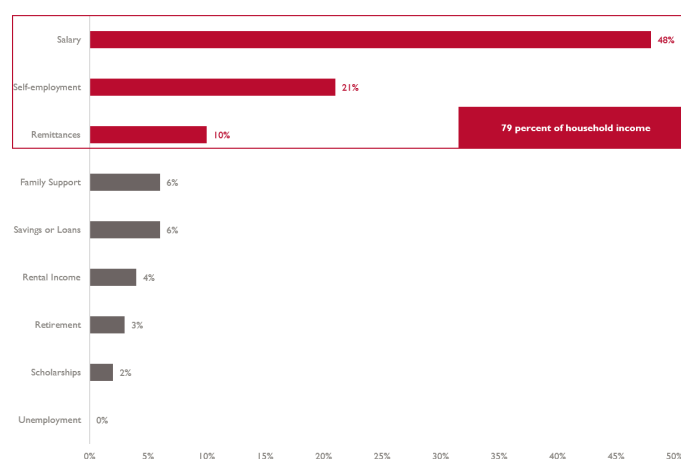
Source: Instituto Nacional de Estadística Honduras: INE

¹ In Honduras, visible underemployment (subempleo visible) occurs when an individual works fewer than 40 hours per week, while invisible underemployment (subempleo invisible) occurs when an individual earns less than the minimum wage and all other employment is considered normal (sin problemas de empleo).

Underemployment is a national phenomenon that extends across all geographic departments, age groups and sexes (Figure 2-17).² Intibucá is the Honduran department with the highest level of underemployment at 82 percent, compared to 43 percent and 41 percent in Cortés and Francisco Morazán, respectively. Underemployment is also prevalent across each age group, accounting for around 50 percent of employment for those 40 and under and around 55 percent for those over 40 and under 60 (Figure 2-18). While labor force participation rates are lower for females, the share of women working in ‘regular’ employment positions (i.e., not in visible or invisible underemployment) is higher than men, and there is a lower percentage of women working in the invisible underemployment category.

Honduras has made some progress in reducing poverty, yet high underemployment, low labor force participation and limited economic opportunities have restricted wealth accumulation at the household level. This is because over 69 percent of average household income comes from salaries and self-employment (Figure 2-19), while the remaining 31 percent consist of remittances (10 percent), family support and loans (6 percent each), and other sources (9 percent). As a result, nearly 15 percent of Hondurans live under the international poverty line of \$1.90 per day, compared to around 1 percent of their population living in extreme poverty (Figure 2-20). Perhaps more concerning, there have not been any reductions in poverty over the past 10 years. Honduras’ poverty gap (5 percent), which measures the average distance of the poor from the poverty line, is also higher than any other comparator country.

Figure 2-19: Share of Household Income by Source (%)

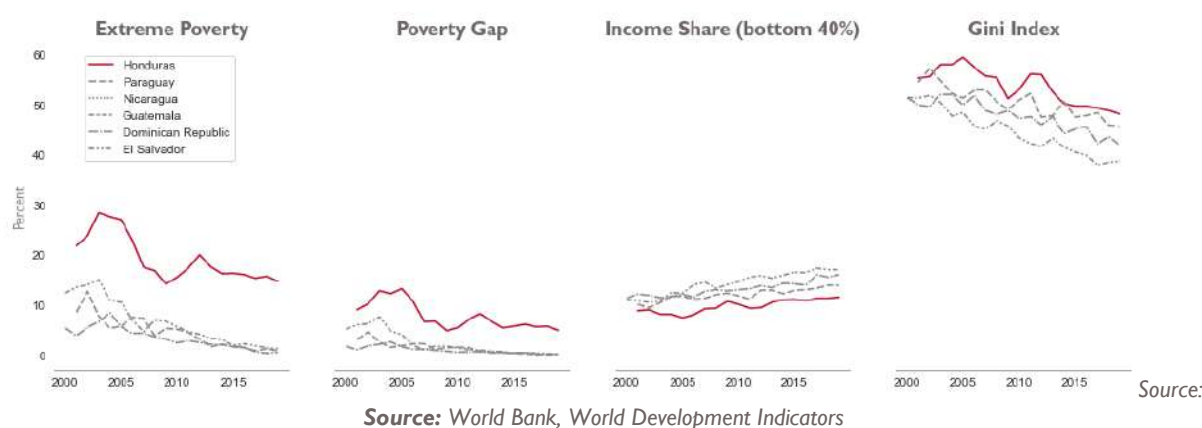


Source: Tercer Encuesta Económica Familiar Multipropósito UNAH. December 2020

Figure 2-20 shows that the income share of the bottom 40 percent of the population has increased to 11.6 percent - the lowest among all comparator countries. While the income share has increased in recent years, it has not done so at the same rate as the reporting comparators. Furthermore, Honduras has a Gini Index rating of 48 (a rating of 0 indicates perfect equality). Although this is higher than any other comparator – indicating higher levels of inequality - the country has made significant strides in reducing its Gini Index rating over the past 20 years.

² A regional breakdown of employment levels was not available for 2019 or 2020. Therefore, the unemployment data figures 1-17 and 1-18 is for 2018 only.

Figure 2-20: Poverty Indicators for Reporting Countries

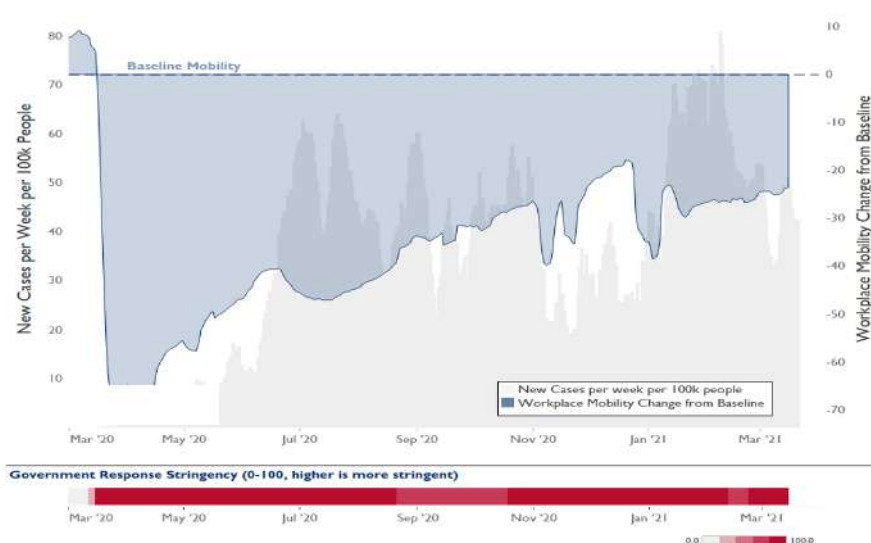


Poverty varies by department in different magnitudes. The departments with the highest extreme poverty rates include Francisco Morazán (12.6 percent) and Cuts (12 percent), while the rest of the country has rates of between 2.2 percent and 7.8 percent. The departments with the highest population densities, have the highest relative poverty rates, including Cortés (20.7%) and Francisco Morazán (17.6%). The lowest poverty rates in the country occur in Ocotepeque and Valle with 1.8 percent and 2.1 percent, respectively.

2.3 RECENT EVENTS

As of March 2021, Honduras had 62 percent fewer COVID-19 related deaths than the regional average; fewer total cases than the Dominican Republic; and a similar number of total cases to Guatemala and Paraguay.³ Figure 2-21 compares the relationship between incidences of COVID-19, government lockdowns, and the mobility of Hondurans. From March 2020 until summer 2020, economic activity, as reflected by workforce mobility, dropped below 70 percent relative to a February baseline. However, since this time workforce mobility has increased to around 20 percent below the baseline period. At the same time, there has been a high level of volatility in the confirmed number of COVID-19 cases, peaking in the first quarter of 2021.

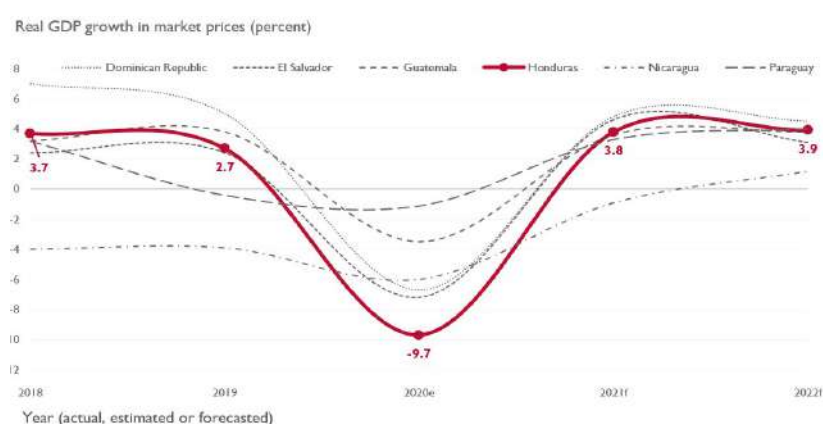
Figure 2-21: COVID-19 Incidence, Government Policy and Workplace Mobility



³ USAID Covid Analytics team using the USAID Situational Dashboard and data from John Hopkins University.

In 2020, Honduras's GDP is expected to have contracted by 9.7 percent due to reduced trade, investment, and private household consumption, as well as the containment measures adopted by the government and the damage caused by hurricanes Eta and Iota (Figure 2-22). The country's economic downturn was more intense than any comparator country, although the scale of the downturn varies by source. For example, data collected by the Economic Commission for Latin America and the Caribbean estimates that the economy contracted by 8.5 percent in 2020. According to the World Bank, Honduras is forecast to rebound to 3.8 percent growth in 2021.

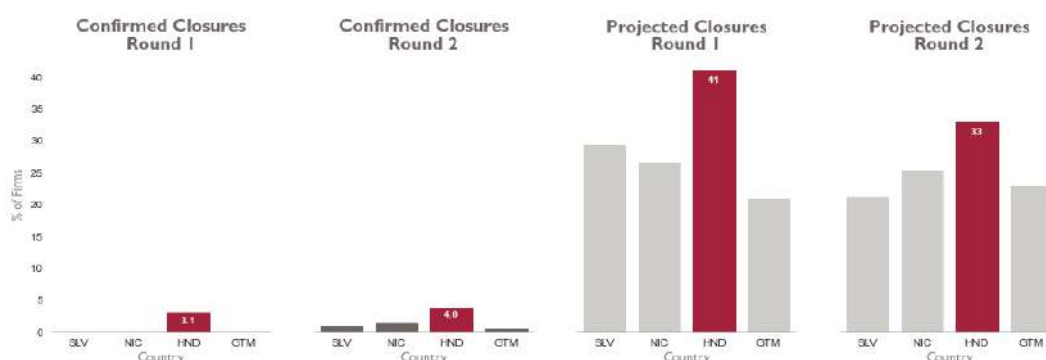
Figure 2-22: Real GDP Growth for Honduras and Comparator Countries



Source: World Bank Global Economic Outlook 2021

The World Bank surveyed over 300 firms to measure the impact of COVID-19 on the private sector, including firms who had participated in the 2016 Enterprise Survey (ES). This work involved two separate rounds of interviews, one between June and August 2020 and the second between November 2020 and January 2021. Figure 2-23 provides a summary of the share of firms that have exited the Honduran market during the pandemic. The first two graphs in Figure 2-23 show the share of firms that were confirmed closed since the 2016 survey, while the next two graphs show the share of firms that are confirmed or assumed to be closed. These projected closures include confirmed closures and firms that could not be contacted for the survey.

Figure 2-23: COVID-19 Confirmed and Projected Closures



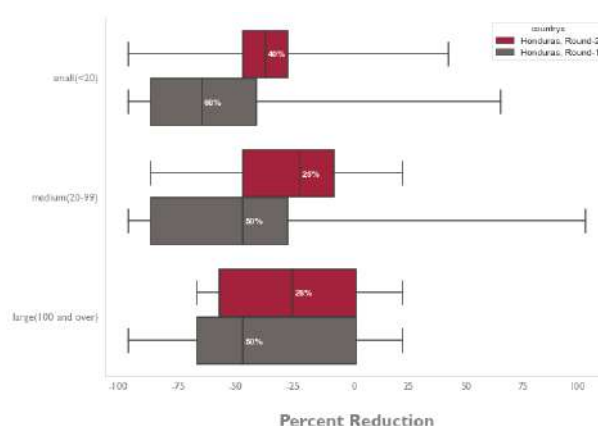
Source: World Bank, Enterprise Surveys Pulse Surveys

Figure 2-23 shows that over 3 percent of Honduran firms were confirmed closed in round 1, compared to 4 percent in round 2. These figures are driven by confirmed closures by small firms (5 - 19 employees), which have reported closures of over 5 percent in the second round compared to 0.3 percent for medium firms (20 - 99 employees) and 0 percent for large firms (100+ employees). The number of assumed and confirmed closures was also higher in Honduras, although this figure

has declined as more firms have responded to the survey or reopened their businesses. Both confirmed and projected closures are higher in Honduras than any of the comparator countries.

Most firms have experienced reduced sales volumes, although the extent of these losses has lessened over time. When asked whether a firm's monthly sales decreased from the same month of the previous year, 91 percent and 80 percent of firms reported sales losses for round 1 and round 2, respectively (Figure 2-24). This was higher than each of reporting comparator countries. For the firms reporting losses, the scale was much greater in the first-round relative to the second.

Figure 2-24: Sales Losses due to COVID-19



Source: World Bank, Enterprise Surveys Pulse Surveys

COVID-19 has also placed a strain on employment outcomes for formal and informal workers. As a measurement of the impact of COVID-19 on the Honduran workforce, including unemployment and underemployment, the World Bank survey asked firms whether the firm experienced a decrease of weekly hours worked relative to one year ago. According to results from the second round of interviews, 52 percent of all firms experienced a reduction in weekly working hours including 61 percent of small firms, 38 percent of medium firms, and 49 percent of large firms.

Although specific estimates for the impact of COVID-19 on Honduras' informal sector were not available at the time of this study, job losses are expected to have been more pronounced for informal workers and the self-employed. Furthermore, participation rates for formal and informal female workers are expected to have fallen as women have left the workforce to take care of family members (ECLAC/ILO 2020). This has likely exacerbated poverty and inequality as many informal workers are not supported by social assistance programs like conditional cash transfers. For example, approximately 60 percent of all Honduran workers are not protected by any social safety net. This figure is much higher for poor and informal workers (Basto-Aguirre et al. 2020).

2.4 SUMMARY

Our analysis of the growth performance in Honduras portrays an economy that has had decent growth driven primarily by private household consumption and remittances. Although COVID-19 has placed a strain on Honduras' economy, remittances and exports have rebounded and firms and workers are returning to economic activities. Nonetheless, compared to the benchmark countries used for this analysis, Hondurans have a greater percentage of its population living in poverty and the country has extremely high levels of inequality. Many Honduran jobs are informal, and the quality of employment has declined in recent years as visible and invisible underemployment has accounted for a larger share of the working population. What might be the binding constraints to inclusive growth in Honduras? In the next sections of this report, we search for answers to this question using the growth diagnostic methodology. We will start by determining if a high cost of finance is constraining growth. We will then consider if low economic returns to investments are constraining growth.

3 HIGH COST OF FINANCE

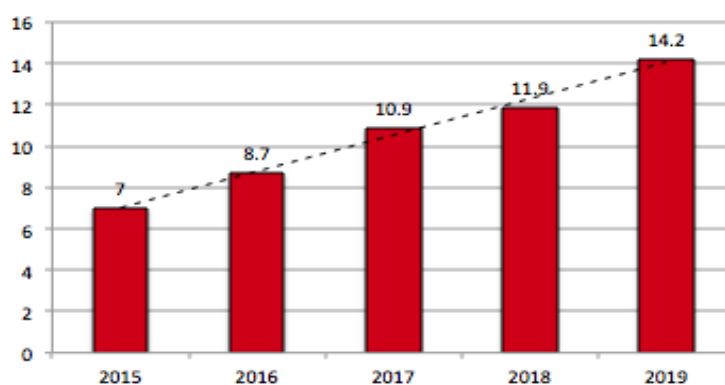
Data suggests that the cost of finance is not a binding constraint to growth in Honduras. The country has a robust financial sector, and a wide array of financial institutions and data has demonstrated that both firms and individuals increasingly access credit and financial services. The real interest rate, which is the cost of accessing finance, is toward the higher end when compared to regional comparators; however, credit to the private sector continues to expand and large and medium-size enterprises access credit at a greater rate than most comparators. In addition to this analysis, the conclusions in this chapter were informed by structured conversations with select regulatory authorities and representatives from a leading private bank in the region.

Regarding inclusivity, small firms have reported a more difficult time accessing finance from banks and a greater proportion are financing investments internally when compared to regional comparators. Similarly, enterprises that have female ownership also have reported a more difficult time accessing finance than firms with no female ownership. However, to articulate this as a constraint to inclusive growth, further exploration is needed.

3.1 BACKGROUND

Honduras has a robust banking sector and a wide variety of financial institutions, including commercial banks, insurance institutions, and several microfinance institutions. Honduras also boasts a high number of service delivery points (14.2 in 2019) per 10,000 adults. According to the National Banking Commission of Honduras, the number of Banking Service Points increased dramatically since 2015 (Figure 3-1), due to a resolution which approved the opening of Correspondent Banking Agents (CBAs). CBAs are entities such as pharmacies and supermarkets that can conduct limited banking transactions on behalf of banks and clients.

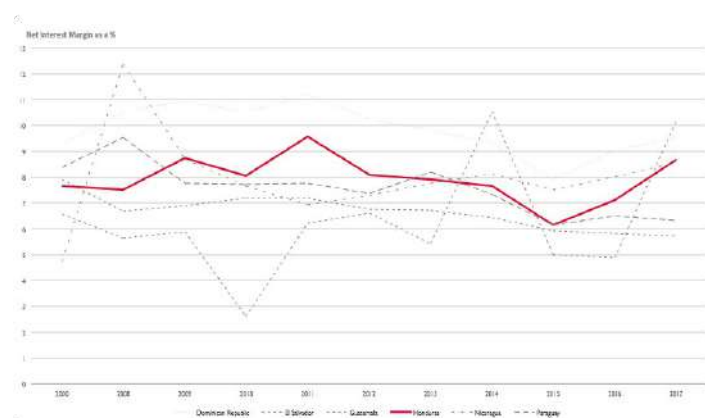
Figure 3-1: Number of Banking Service Points for every 10,000 Adults (2015 - 2019)



Source: Comisión Nacional de Bancos y Seguros de Honduras (CNBS).

As cited by the World Bank, Honduras's rate of non-performing loans is low at 2.3% in 2019 and the net interest margin, which is an indicator of the overall profitability of banks, falls within the range of regional comparators (Figure 3-2). These data suggest that Honduran banks are reasonable and efficient financial intermediaries relative to the region.

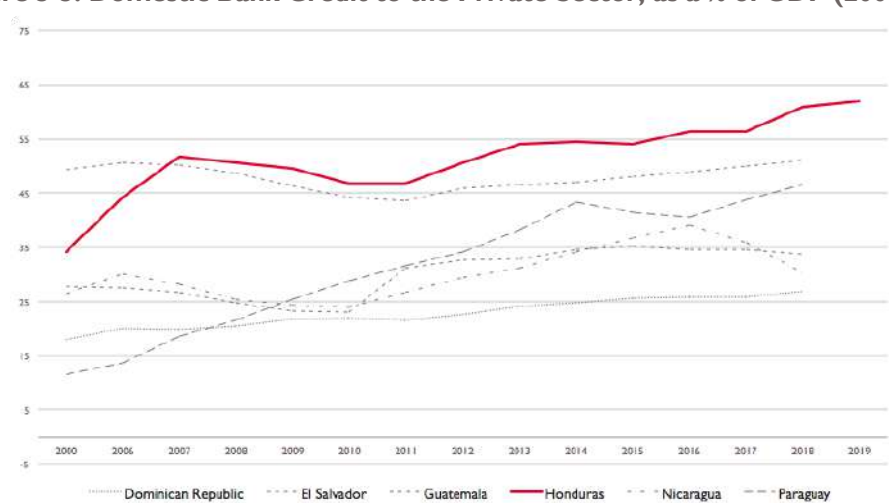
Figure 3-2: Net Interest Margin by Country (2000-2017)



Source: World Bank Development Indicators

Domestic credit to the private sector has grown steadily since 2000 and has far outpaced regional comparators (Figure 3-3). For 2018, the National Banking Commission of Honduras noted that the total loan balance for commercial banks consists of 39.9 percent consumption and credit cards, 29.4 percent housing, 22.3 percent commercial loans, and 2.5 percent microcredit (Reporte de Inclusión Financiera, 2019).

Figure 3-3: Domestic Bank Credit to the Private Sector, as a % of GDP (2000 - 19)



Source: World Bank Development Indicators

3.2 DIAGNOSTIC TESTS

To evaluate whether the cost of finance is a binding constraint to growth, this analysis undertook four diagnostic tests. The results of these tests are summarized below.

3.2.1 TEST 1: IS THE SHADOW PRICE OF THE CONSTRAINT HIGH?

If the cost of finance is a constraint to growth in Honduras, we would expect the shadow price of the constraint to be high. The real interest rate in Honduras is the price of accessing finance and is one of the highest when compared to the comparators (Figure 3-4). The real interest rate as a percentage has oscillated between 10-20% over the last 14 years (Figure 3-5). When looking at the 5-year average of the real interest rate (2012-2017), Honduras is the second highest (14.62%) after Paraguay (15.13%).

Figure 3-4: Avg. Real Interest Rate (2012 - 17)

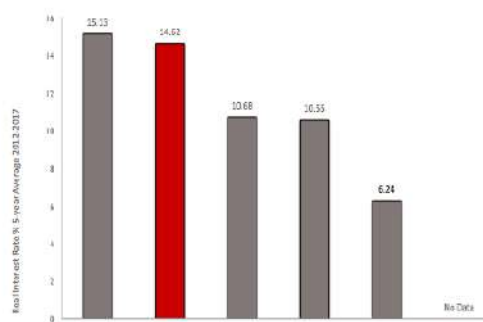
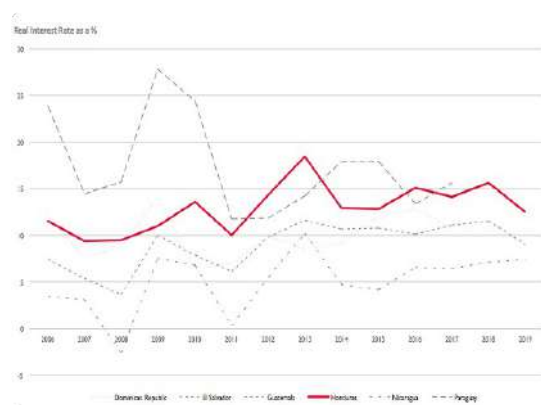


Figure 3-5: Real Interest Rate (2000-2019)

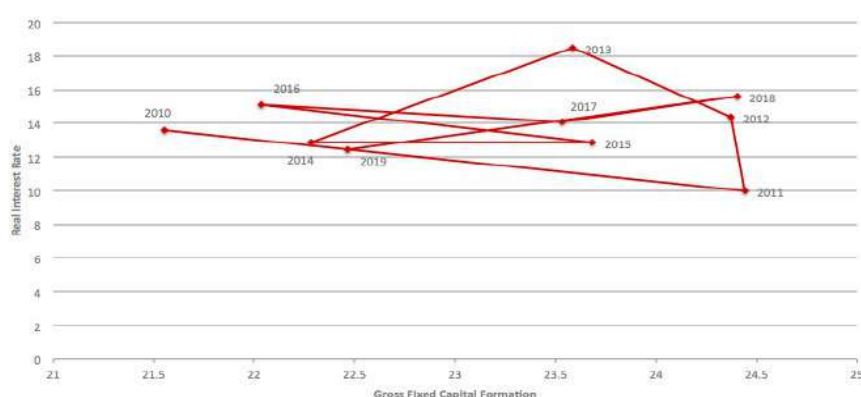


Source: World Bank Development Indicators

3.2.2 TEST 2: DO CHANGES IN REAL INTEREST RATES AFFECT INVESTMENT?

If access to finance is a constraint, then changes to the interest rate should lead to significant movements in investment. In Honduras, when real interest rate changes are compared with investment (gross fixed capital formation as a % of GDP), no causal relationship is observed (Figure 3-6). However, this does not necessarily rule out the cost of finance as a constraint, which is why tests 3 and 4 are conducted.

Figure 3-6: Real Interest Rate vs Gross Fixed Capital Formation (2009-2019)

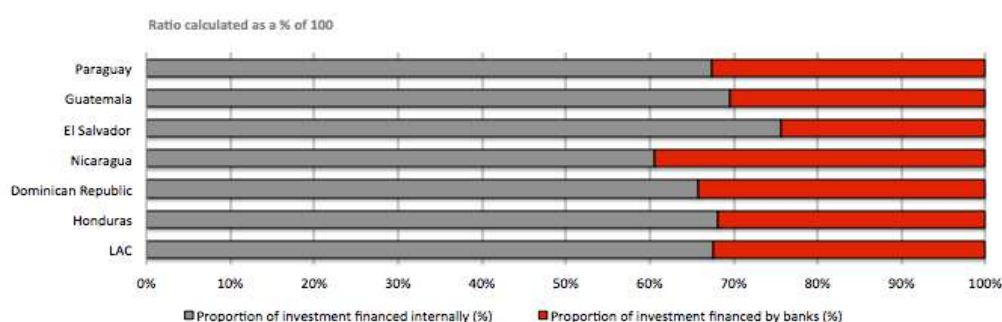


Source: World Bank Development Indicators

3.2.3 TEST 3: DO WE OBSERVE FIRMS ATTEMPTING TO BYPASS THE CONSTRAINT?

If the cost of finance is a constraint to growth, we should observe firms acknowledging and attempting to bypass the constraint. We should see a higher proportion of investment financed internally and a lower proportion of investment financed by banks when compared to comparators. However, results from the 2016 World Bank Enterprise Survey (Figure 3-7) indicate that the ratio of firms financing investment internally and by banks aligns with the LAC regional average and falls within range of the selected comparator countries. This suggests that firms are not trying to bypass the constraint.

Figure 3-7: Proportion of Investment Financed Internally and by Banks



Source: World Bank Enterprise Survey 2016.

When disaggregated by firm size (Table 3-1), we see the proportion of investment financed by banks by medium (44.6%) and large firms (44.1%) exceed the LAC average (31.8% and 38.1% respectively). These figures also surpass of many the comparator countries. In table 3-2, the proportion of investment financed internally for medium firms (28.4%) falls well below the regional LAC average (52.2%). For large firms it falls below that of many comparators. The data suggests that medium and large firms are not trying to bypass a high cost of finance.

Table 3-1: Proportion of Investment Financed by Banks (%)

COUNTRY	DISAGGREGATION BY FIRM SIZE			
	AVERAGE	SMALL (5-19)	MEDIUM (20-99)	LARGE (100+)
Dominican Republic	28.3	40.9	14.6	18.6
El Salvador	20	10.7	29.4	37.4
Guatemala	25.5	20.1	28.2	42
Honduras	26.1	17.1	44.6	44.1
Nicaragua	36.4	24.9	50.5	38.3
Paraguay	25.3	21.8	28.7	25.4
Latin America & Caribbean	26.9	21.6	31.8	38.1

Source: World Bank Enterprise Surveys

However, for small firms, the proportion of investment financed internally (65.7%) is significantly higher than the regional LAC average (58.7%) and many comparator countries. Similarly, the proportion of investment financed by banks (17.1%) falls below the LAC Average (21.6%) and falls below all comparator countries except for El Salvador.

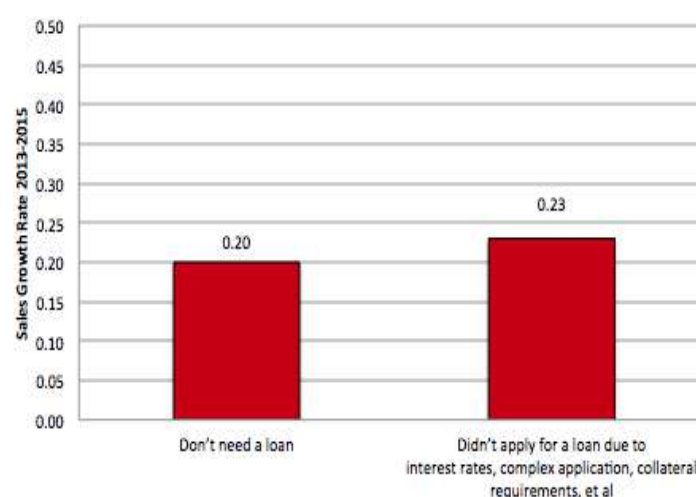
Table 3-2: Proportion of Investment Financed Internally (%)

COUNTRY	DISAGGREGATION BY FIRM SIZE			
	AVERAGE	SMALL (5-19)	MEDIUM (20-99)	LARGE (100+)
Dominican Republic	54.6	41.9	65.2	71.7
El Salvador	62.3	63.4	65.1	54.2
Guatemala	58	61	55	51.3
Honduras	55.9	65.7	28.4	55.9
Nicaragua	56.1	70.5	39	47
Paraguay	52.2	49.4	48.6	64.7
Latin America & Caribbean	55.9	58.7	52.2	50

Source: World Bank Enterprise Surveys

3.2.4 TEST 4: DO FIRMS THAT ARE MORE HINDERED BY THE CONSTRAINT PERFORM WORSE THAN FIRMS THAT ARE LESS HINDERED BY THE CONSTRAINT?

If access to finance is a constraint, firms less dependent on accessing finance should fare better than firms who are more dependent. More specifically, firms that indicated in the 2016 World Bank enterprise surveys that they do not need a loan, should fare better than firms who did not apply for a loan due to high interest rates, complex application processes, high collateral requirements, or other administrative factors. The 2016 World Bank enterprise survey results showed no statistically significant difference (P score = 0.80) in sales growth and performance between firms that stated they do not need a loan and firms that did not apply for a loan due to interest rates, complex application, collateral requirements, or other administrative factors (Figure 3.8).

Figure 3-8: Sales Growth Performance by Loan Dependency

Source: World Bank Enterprise Surveys

3.3 INCLUSIVITY

While the diagnostic tests indicate that finance is not a constraint to overall growth, it does present greater obstacles for small and women-owned firms. Firms that have reported female ownership identified finance as a major constraint at a higher rate when compared to firms with no reported female ownership (Figure 3.10). Moreover, small firms identified finance as a major constraint at a higher rate than medium and large firms (World Bank Enterprise Surveys).

Figure 3-9: Small Firms that Identify Finance as a Major Constraint

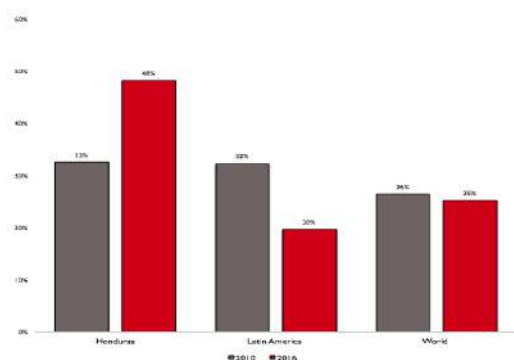
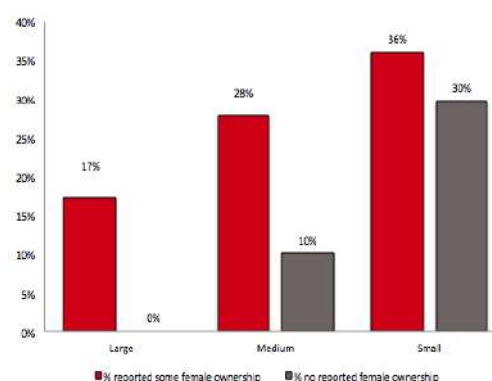


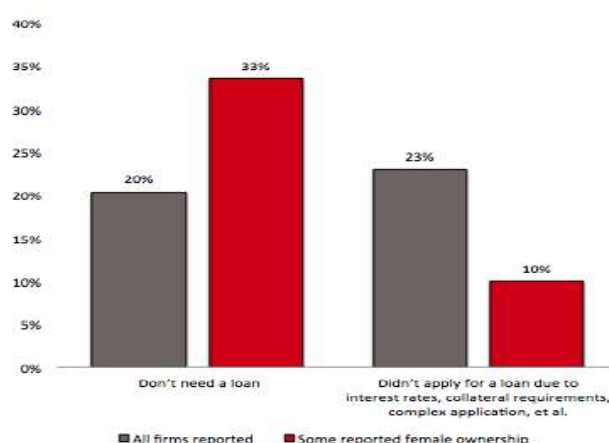
Figure 3-10: Access to Finance as a Major Constraint by Size and Owner's Gender



Source: World Bank Enterprise Surveys

World Bank Enterprise Survey Data from 2016 shows that small firms identify finance as a major constraint at a higher rate than the rest of LAC (Figure 3-9) and that small firms tend to bypass the constraint and internally finance investment at a significantly higher rate than comparators and the LAC average (Table 3-2). Firms with some female ownership identify finance as a major constraint at a higher rate than those that report no female ownership (Figure 3-10), and notably only firms that reported female ownership had a loan rejected. The mean sales growth for firms that stated they did not need a loan and had sufficient capital was 20% compared with 23% (P score: 0.80, i.e., no statistical difference) who stated they did not apply for a line of credit or loan due to complex application procedures, interest rates, collateral, and other factors. These means diverge to 33% and 10% (Figure 3-11) respectively for firms with female ownership. However, the sample size is too small to make any robust conclusion and the P score (0.24) is not statistically significant.

Figure 3-11: Sales Growth by Loan Dependency and Owner's Gender



Source: World Bank Enterprise Surveys

4 INFRASTRUCTURE

In the previous chapter, we concluded that it is unlikely that Honduras' potential binding constraints are associated with a high cost of finance. In this chapter, we will consider whether poor infrastructure is constraining economic growth. This will include three subsets of infrastructure: (1) energy; (2) transport; (3) information and communications technology (ICT); and (4) water and sanitation. We conclude that none of these subsets of infrastructure are potential constraints to economic growth.

However, inclusive growth is likely constrained by poor rural access to energy, transport, and mobile and Internet communications. Specifically, the rural population has limited access to the national electric grid and all-season roads and Honduras performs poorly in terms of various global indexes measuring the quality of national ITC systems. The country should continue its efforts of expanding rural access to energy and roads and improve national access to high-quality ICT.

4.1 ENERGY

Honduras has a little over 2,600 megawatts (MW) of installed capacity and 1,600 MW of maximum demand. Almost 60 percent of Honduras' installed capacity comes from fossil fuels and hydroelectric power, while another 28 percent comes from solar and wind (Figure 4-1). From 2020 to 2029, installed capacity is projected to increase by 43 percent, while demand is expected to increase by 40 percent (Figure 4-2). According to the International Energy Association (IEA), residential customers account for 36 percent of demand compared to 33 percent and 31 percent for commercial and industrial customers, respectively (2020). Although installed capacity represents the total potential electricity that can be supplied by Honduras' electrical grid, fixed power is a more accurate representation of energy that can be consistently used to meet demand. Figure 4-2 shows that Honduras' fixed energy supply is just barely under what is required to meet expected demand.

Figure 4-1: Installed Capacity by Source

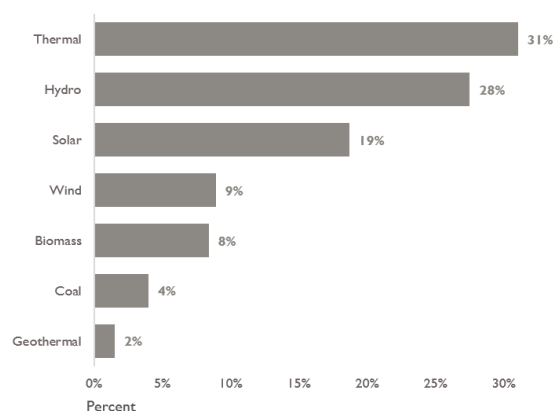
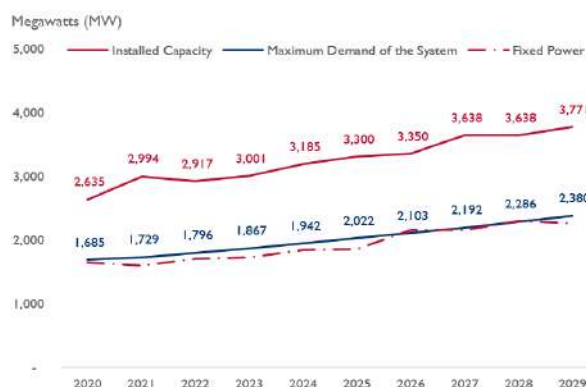


Figure 4-2: Energy Supply and Demand



Source: *Operador del Sistema (2019)*

Although power consumption is at the expected level given Honduras's wealth (Figure 4-3), transmission and distribution losses are higher than any comparator and 1.75 times greater than what would be expected (Figure 4-4). These losses are reportedly due to theft, fraud, and illegal connections (IADB 2010). Furthermore, the National Electric Power Company (ENEE), the organization responsible for production, marketing, transmission, and distribution of electric power, has accumulated an operating deficit of around 85 billion lempiras (\$3.5 billion) that continues to grow. This constraint limits many of the efforts to reform the electricity sector. Moreover, many of the planned reforms have only been partially implemented due to financing constraints tied to the growing deficit.

Figure 4-3: Power Consumption per Capita

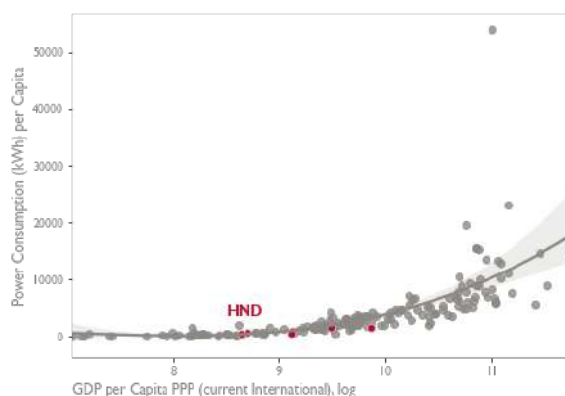
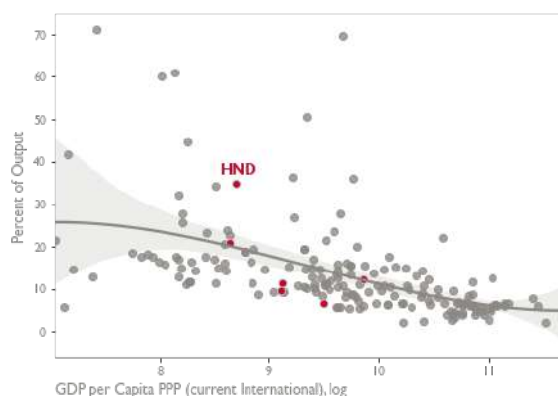


Figure 4-4: Energy Losses (%)



Source: World Bank, World Development Indicators (2015)

Nearly 70 percent of firms reported experiencing a power outage in 2016. This was the second highest among comparator countries although near the expected level given Honduras's wealth. Similarly, monetary losses due to power outages were higher than any other comparator yet lower than expected given the country's income level. There also could be losses tied to the poor quality of electricity. As a result of the volatile electricity supply, Honduran firms had the 2nd highest level of generator ownership at 24 percent (Figure 4-5). However, ownership was much lower than the Dominican Republic (49 percent). Of those firms owning a generator, 20 percent of their energy comes from this source - this was the second highest relative to the comparators (Figure 4-6).

Figure 4-5: Generator Ownership (%)

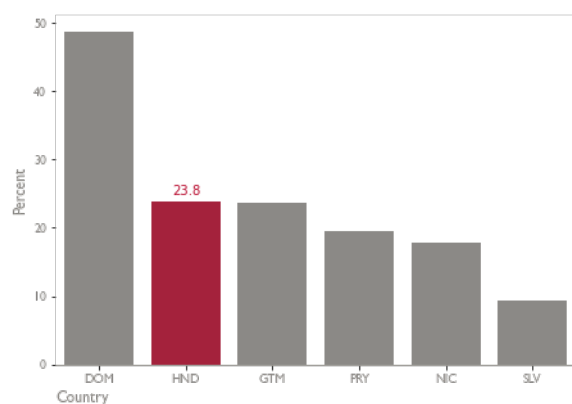
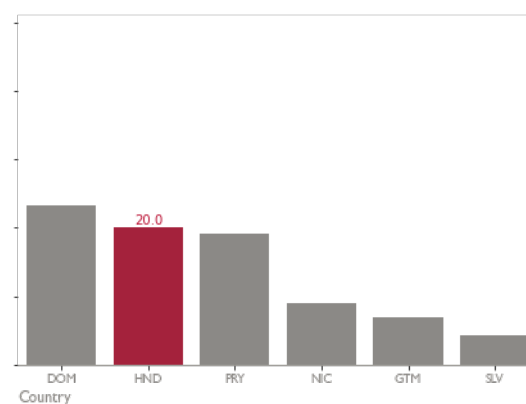


Figure 4-6: Energy from Generators (%)



Source: World Bank, Enterprise Surveys (2016)

A little over 3 percent of firms identified electricity as a major obstacle to their business - the second lowest percentage among the comparator countries. Like other comparator countries, the percentage of firms identifying electricity as a major obstacle is much lower than what would be expected for a country with its income level. One of the reasons may be due to the comparable energy prices. From 2015 to 2020, the price of electricity fell from \$0.25 to \$0.21 (Figure 4-7). While Honduras has the second highest electricity costs, it has lower costs than Nicaragua and similar costs to 3 out of the 5 comparator countries. According to data from the Asociación Nacional de Generadores, the low relative prices hold across customer groups and levels of use.

Figure 4-7: Cost of Electricity (2015 - 20)

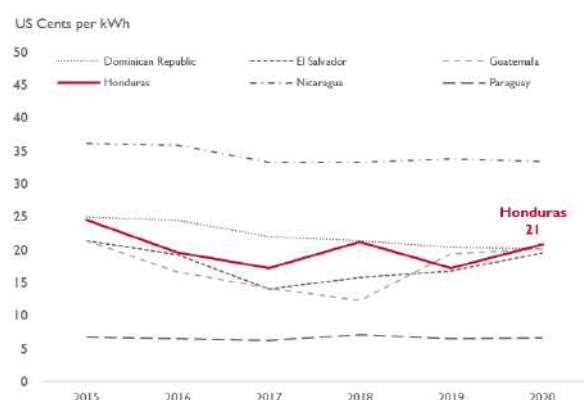
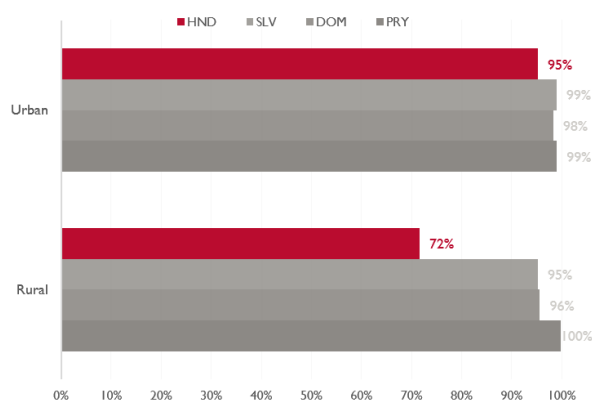


Figure 4-8: Electricity Coverage (2019)



Source: Doing Business 2020; Sistema de Información Energética de Latinoamérica y el Caribe (sieLAC)

The value added in manufacturing and services as a percent of GDP is average in Honduras relative to comparator countries, providing no evidence that electricity-intensive sectors are performing worse than those that are less electricity-intensive. However, the lack of access to electricity in rural areas is glaring. Only 85 percent of the population has access to the electric grid - the lowest of any comparator. Moreover, only 72 percent of the rural population has access to the grid, over 20 percentage points lower than any reporting comparator country (Figure 4-8).

4.2 TRANSPORT AND LOGISTICS

The accessibility and quality of Honduras' infrastructure is driven by the country's established transport corridors. Firms and people living along these corridors have access to water, energy, ITC and greater economic opportunities. The country is working to expand these corridors, but progress is slow. However, Honduras' overall score in the LPI Index (Figure 4-9) and its LPI score for the quality of infrastructure (Figure 4-10) is at the expected level for a country with its wealth status. The country also performs well relative to comparators and has an overall country rank of 93rd - behind only Paraguay and the Dominican Republic.

Figure 4-9: LPI Score and GDP

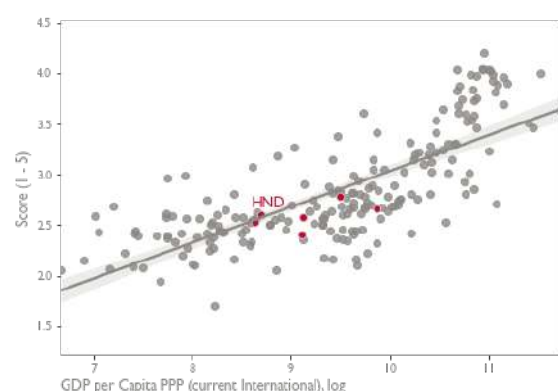
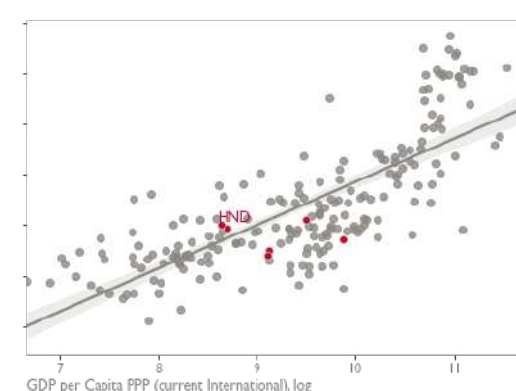


Figure 4-10: LPI Infra. Score and GDP



Source: Logistics Performance Index (LPI)

Honduras performs relatively well in almost all areas of the LPI. The one exception is the timeliness index score, which measures the frequency with which shipments reach consignees within scheduled or expected delivery times. Honduras' score for timeliness is second lowest among comparators at 2.67 out of 5. The country also performs relatively poorly relative when considering the density of its road networks. Honduras has expanded its road density from 0.13 to 0.15 Km/Km2 but it has the

lowest road density among comparators and most access is tied to the country's primary transportation corridors (Figure 4-11). While less than 24 percent of Honduras' 16,476 kilometers of roads are paved, this is higher than Nicaragua and Paraguay (Figure 4-12).

Figure 4-11: Road Density (2018)

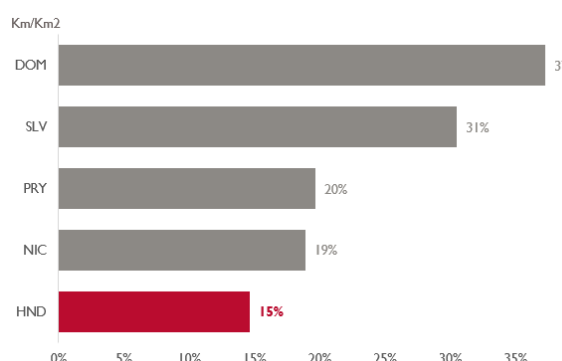
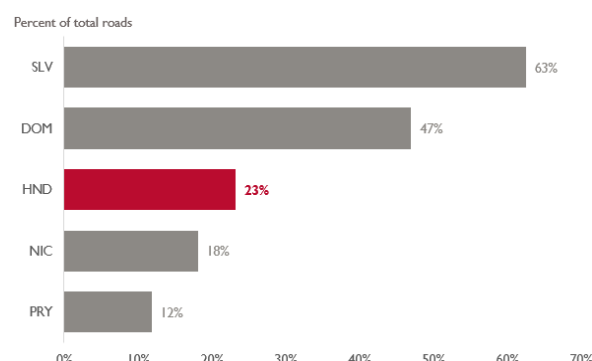


Figure 4-12: Paved Roads (2018)



Source: El Salvador, Fondo de Conservación Vial de El Salvador - 3er Congreso del Asfalto Salvadoreño; El Salvador, Fondo de Conservación Vial de El Salvador - 3er Congreso del Asfalto Salvadoreño; Nicaragua, Anuario Estadístico de Transporte 2018 - Ministerio de Transporte e Infraestructura; Paraguay, Ministerio de Obras Públicas y Comunicaciones - Banco de Desarrollo de América Latina CAF; Dominican Republic, Ministerio de Obras Públicas y Comunicaciones - Plan Nacional de Infraestructura 2020-2030.

The IADB reports that Honduras has one of the highest road freight costs (2019). However, the IADB does not provide a data source for this information. The Honduran Institute of Land Transportation established fixed minimum rates for cargo transportation (2018). For example, there is a minimum rate of 1.24 US\$/km for transporting cargo with a distance greater than 60 km. Although these costs are considered high by many Hondurans, we did not have enough pricing information from the benchmark countries to compare the relative pricing of transporting goods in Honduras.

Honduras performs relatively well in the Liner Shipping Index, but its index score has declined in recent years (Figure 4-13). This decline may be due to recent laws setting a fixed price for container ships, as well as the separation of government institutions managing the customs process. The country performs well with regards to the volume of container shipments. The most recent cost data for shipping exports is from 2014 so this information is not assessed for this analysis.

Figure 4-13: Line Shipping Connectivity Index

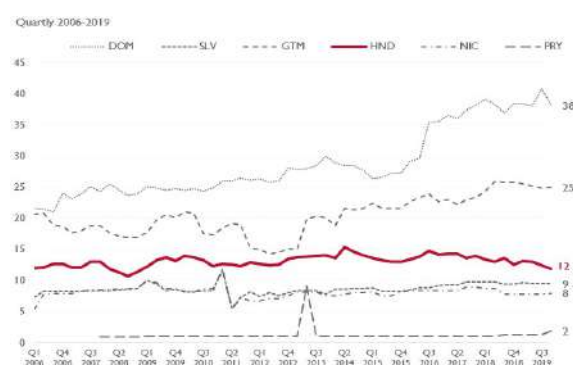
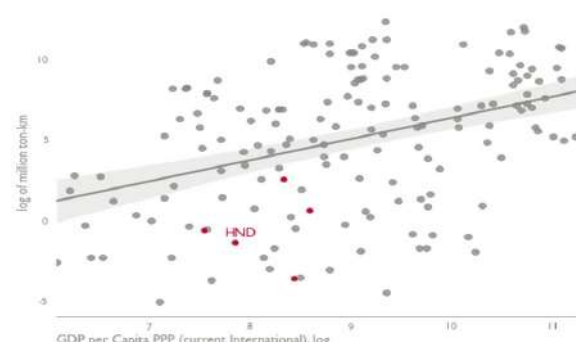


Figure 4-14: Air Transport Freight and GDP per Capita, PPP



Source: UNCTAD Liner Shipping Connectivity Index (LSCI); World Bank WDI

Air transport is constrained by the small size of the Honduran market and the absence of a regional transport hub that can handle large air transport traffic. Most countries within close geographic proximity encounter the same barriers, which is reflected in the low air transport volumes for many

of the comparators. For instance, Honduras has fewer passengers and air transport freight than would be expected for a country with its wealth level, yet it does have a higher number of passengers relative to the comparator countries. Honduras also has exceptionally low air freight volumes and places second lowest when compared to the benchmark countries (Figure 4-14).

Transport is identified as a major obstacle by 2.1 percent of firms, which is lower than Paraguay (4.9 percent) and Guatemala (3.7 percent) yet higher than Nicaragua, El Salvador, and the Dominican Republic (Figure 4-15). The percentage of firms identifying transport as a major obstacle is also lower than the expected level given Honduras's income level. Although only 31 percent of Honduras's rural population has access to an all-season road, this is slightly higher than three out of the five comparator countries (Figure 4-16).

Figure 4-15: Transport as a Major Obstacle

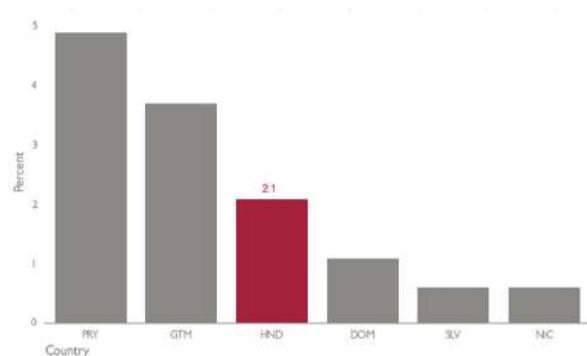
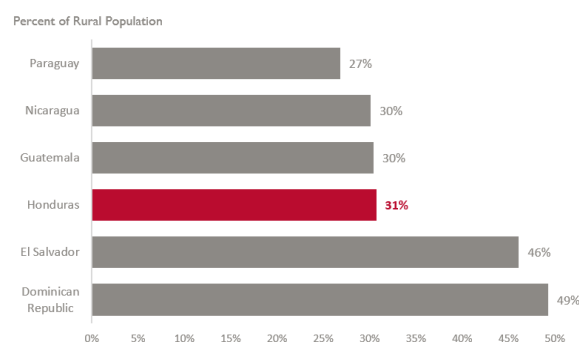


Figure 4-16: Rural Access Index



Source: World Bank Enterprise Survey; World Bank, Rural Access Index (2019).

4.3 INFORMATION, TECHNOLOGY, AND COMMUNICATIONS (ITC)

Honduras has a country ranking of 124th out of 141 countries in the World Economic Forum (WEF) ICT adoption pillar, which is lower than all other comparator countries. This low ranking is mainly driven by low mobile subscriptions at only 79 subscriptions per 100 people (123rd), as well as low mobile broadband adoption at 32 subscriptions per 100 people (119th). Honduras also has a low country ranking (112th) for internet subscriptions at 32 percent of the total adult population.

The E-Government Development Index (EGDI) assesses how countries use information technology to expand access and inclusivity among its people. The EGDI is made up of 3 sub-indexes: online services, telecommunication infrastructure, and human capital. Honduras has an EGDI country ranking of 138th out of 191 countries and places lower than every comparator country in each of the EGDI sub-indexes. Low mobile subscriptions and Internet use are driving the country's particularly low scores in the telecommunications infrastructure sub-index.

Figure 4-17: Mobile Subscriptions (2009 - 19)

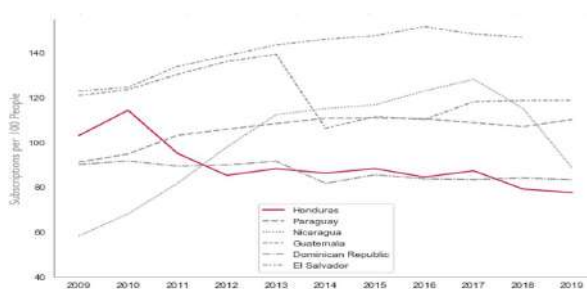


Figure 4-18: Internet Use (2009 - 19)



Source: World Bank Development Indicators (2019); World Economic Forum (2019)

Both mobile and fixed phone subscriptions have been declining over the past 10 years (Figure 4-17). One potential explanation for this declining trend is the consolidation of mobile phone devices as carriers have either increased coverage or entered sharing agreements with competitors to expand coverage. From 2009 to 2019, Internet use increased from 5 percent to 32 percent of the adult population (Figure 4-18), while fixed broadband subscriptions have continued to increase and are at comparable levels relative to the benchmark countries.

Figure 4-19: Mobile Subscriptions Vs GDP

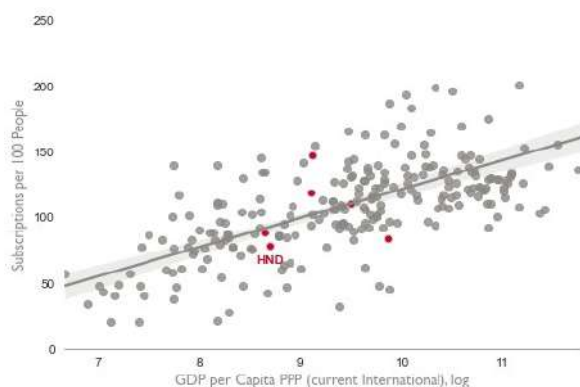
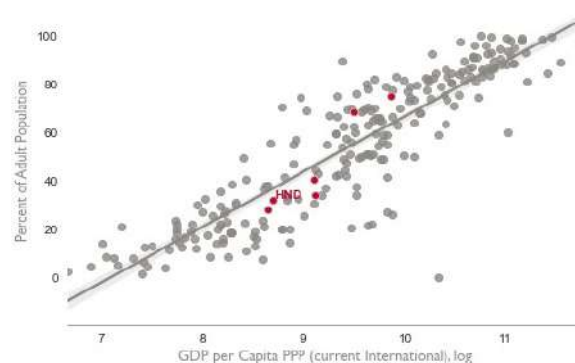


Figure 4-20: Internet Use Vs. GDP



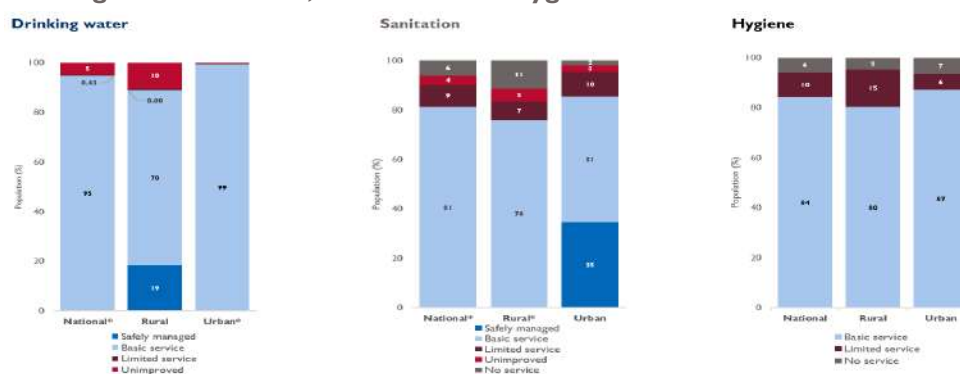
Source: World Bank Development Indicators; WEF (various years)

Honduras has fewer subscriptions that would be expected for a country with its level of wealth, while fixed phone subscriptions are near expected levels (Figure 4-19). Approximately 32 percent of the population has access to the Internet and 4 percent have access to broadband. This level of basic Internet connectivity is slightly lower than what would be expected for countries with similar wealth levels Figure 4-20.

4.4 WATER AND SANITATION

According to the Joint Monitoring Programme for Water Supply, Sanitation and Hygiene, 95 percent of the population has access to “basic” drinking water, although this figure drops to 70 percent in rural areas (Figure 4-21). Basic and safely managed sanitation is provided to over 80 percent of the population, though this figure drops to 76 percent that have basic sanitation in rural areas. Over 80 percent of the urban and rural population have access to handwashing facilities (hygiene). According to data from the World Bank, Honduras' population has relatively decent access to water at both the national and rural level. For example, 95 percent of the total population and 87 percent of the rural population has access to water. These figures are higher than most comparators and higher than what would be expected for a country with its income level.

Figure 4-21: Water, Sanitation and Hygiene Indicators for Honduras

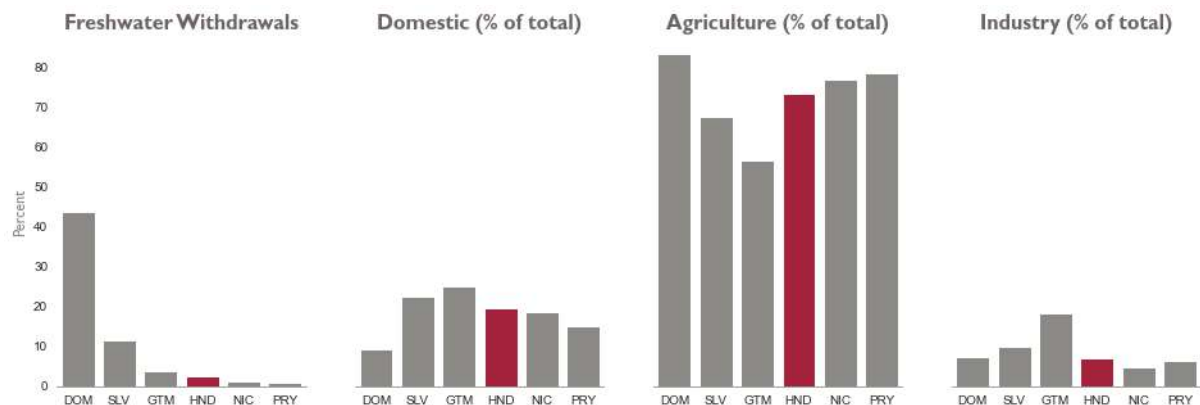


Source: WHO/UNICEF JMP (2019)

***Note:** No safely managed estimates available

Honduras annually withdraws 2.5 percent of its freshwater resources - the second lowest among comparators and below the expected level for a country with its income level. Similarly, Honduras has the lowest level of water insufficiencies. Like comparators, most withdrawals (73 percent) go towards agriculture, while withdrawals going to domestic, and industry are at a similar level (Figure 4.22). There were no time series data available to show how the sector share of freshwater withdrawals has changed over time.

Figure 4-22: Freshwater Withdrawals by Sector and Country (2017)



Source: World Bank Development Indicators

5 HUMAN CAPITAL

There is strong evidence to suggest that human capital is a binding constraint to inclusive growth in Honduras. Honduras has low levels of educational attainment, particularly in rural areas, contributing to persistently high returns to schooling and a high proportion of firms citing human capital as a “major” or “severe” constraint to doing business. While Honduras has made significant progress in access to primary education, enrollment and completion rates at the secondary and tertiary levels remain among the lowest in the LAC region, with significant disparities between students in urban and rural areas.

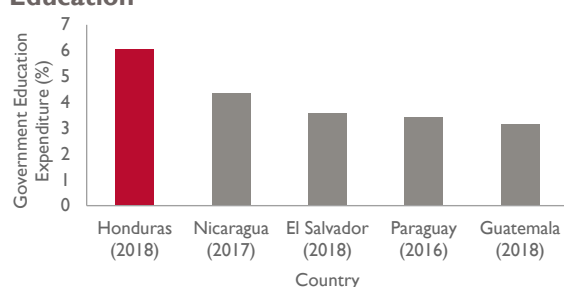
Paradoxically, however, labor force participation in Honduras is also exceptionally low, even among individuals with higher levels of education, and underemployment rates - both visible and invisible - are climbing. This challenge is particularly salient among women, who have some of the lowest rates of labor force participation in LAC, even as women’s educational attainment has largely kept pace with men. There appears to be a significant undersupply of high-quality jobs which, combined with high remittance receipts and high monetary returns to migration, discourage labor force participation.

Taken together, low educational attainment, poor labor market conditions, and high levels of migration appear to have created a vicious cycle wherein the Honduran labor market is unable to absorb the glut of low to medium-skilled workers, creating incentives for workers to migrate. This migration in turn drains Honduras of vital human capital while raising workers’ reservation wages within the country, reducing Honduras’ competitiveness, and stymying overall economic growth.

5.1 EDUCATION SPENDING

The Honduran government spends more on education than any other comparator country as a percentage of GDP, at 6.1 percent in 2018 as shown in Figure 5-1. While this figure represents a

Figure 5-1: Government Expenditure on Education



Source: World Bank World Development Indicators

decrease from an all-time high of 7.6 percent of GDP in 2009, it is still well above the level of spending that would be expected for a country of Honduras’ income level, as well as the average level of spending among OECD countries.⁴ Primary education comprises the bulk of education expenditures, at 48 percent, followed by secondary education (25 percent) and tertiary education (18 percent). This distribution is generally aligned with comparator countries.

Despite these large investments in education, the Honduran education system continues to struggle with issues of infrastructure, quality, and training. This may in part be due to the large wage bill, which has comprised between 87 and 93 percent of education spending from 2007 to 2017. This is higher than Nicaragua, Paraguay, and El Salvador (the only countries for which this data point was available), who spent an average of 70 percent of their education budget on wages,⁵ as well as the

⁴ World Bank (2014), “Central America Social Expenditures and Institutional Review: Honduras”

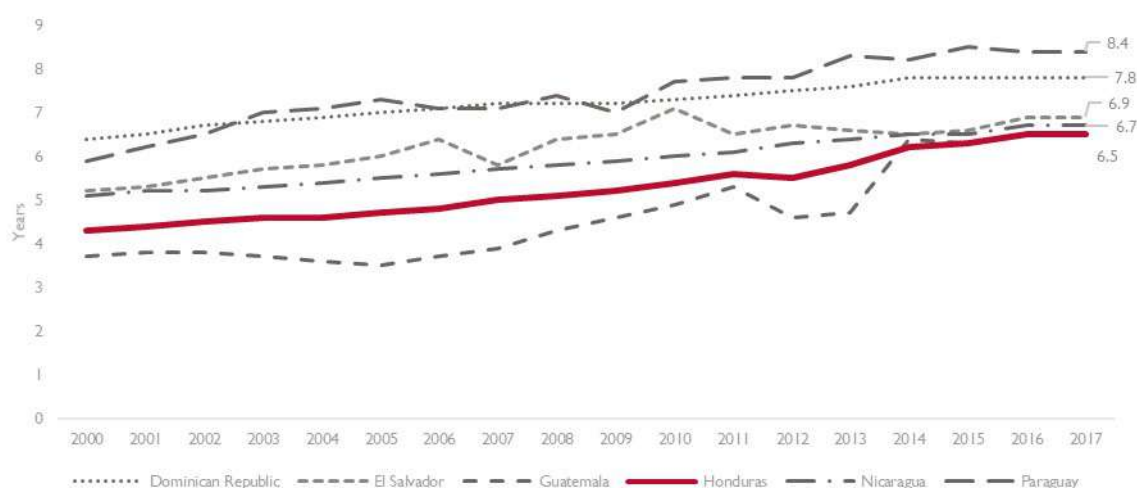
⁵ Ibid

Latin America and Caribbean average of 76 percent.⁶ It is important to note that the world's highest performing education systems in terms of test scores - including South Korea and Finland - typically spend around 50 percent of their education budget on wages. Within Latin America and the Caribbean specifically, Costa Rica, which is ranked among the best performing education systems in the region according to OECD PISA scores, spends approximately 60 percent of its education budget on wages, suggesting that Honduras' education spending may not be optimally allocated to ensure the greatest benefit to students.⁷

5.2 ENROLLMENT AND COMPLETION

Overall educational attainment in Honduras has improved steadily over the past two decades, from just 4.3 years in 2000 to 6.5 years in 2017. However, this average remains well below the comparator country average of 7.3 years, as shown in Figure 5-2.

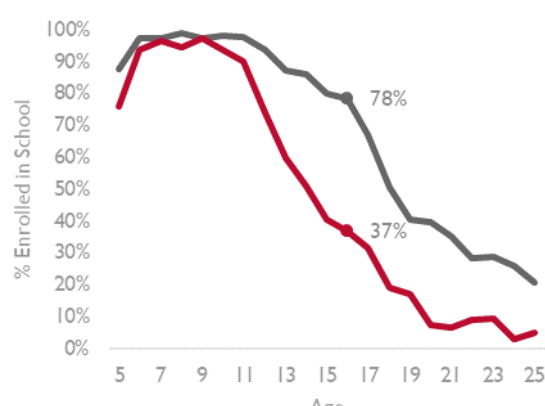
Figure 5-2: Mean Years of Schooling (2000 - 2017)



Source: Lee-Lee (2016), Barro-Lee (2018), and UNDP (2018)

Honduras has made significant strides in ensuring near-universal access to primary education. Net primary school enrollment is high, at 95 percent, and there are no significant differences in enrollment rates between male and female students. However, enrollment begins to drop precipitously by age 12, with significant disparities between urban and rural populations, as well as poor and non-poor households. By the time students reach secondary school, these gaps have widened even further: at age 16, just 37 percent of children in rural areas are enrolled in school compared to 78 percent of children in urban areas (a 40-percentage point gap).

Figure 5-3: School Enrollment by Age



Source: Encuesta Permanente de Hogares de Propósitos Múltiples (EPHPM), 2019

⁶ Hernandez, O., Sousa, L. D., & Lopez, J. H. (2015), "Honduras: Unlocking Economic Potential for Greater Opportunities", World Bank.

⁷ World Bank (2014), "Central America Social Expenditures and Institutional Review: Honduras"

While disparities in school enrollment between urban and rural areas is a common challenge across Latin America and the Caribbean, available data suggests that the issue is particularly pronounced in Honduras. In Nicaragua, for example, there is a 30-percentage point gap in school enrollment between 16-year-olds in rural and urban areas.⁸

The reasons children drop out of school are varied but are most frequently related to economic factors. A 2019 survey conducted by the Norwegian Refugee Council and NORAD found that the primary reasons children cited for leaving school included economic problems (69 percent of out-of-school children), food insecurity (27 percent), need to support the household (19 percent), lack of uniforms (16 percent), problems with other household members (12 percent), and distance from school (10 percent).⁹ A separate World Bank study found that the proportion of students who cite economic insecurity as their primary reason for dropping out of school is higher in Honduras than anywhere else in Central America, at 53 percent.¹⁰

Economic insecurity as a driving factor behind school dropouts intersects closely with geographic and demographic characteristics. A 2016 World Bank study found that being located in a rural area decreases a student's likelihood of attending secondary school by 16 percent, identifying as indigenous decreases attendance likelihood by 8 percent, while hailing from a household that is classified as poor (according to national poverty line statistics) decreases attendance likelihood by 7 percent.¹¹ Disparities in access to school facilities between urban and rural locations exacerbates and amplifies these existing socioeconomic inequalities, and improvements in access will require significant levels of investments in infrastructure on the part of the Honduran government. As the World Bank noted in its 2016 Systematic Country Diagnostic, "Assuming that the 192 rural secondary schools in 2012 were already operating at full capacity, a staggering 1,079 additional schools would be required to serve all rural students."¹²

5.3 QUALITY AND RELEVANCE

5.3.1 PRIMARY AND SECONDARY EDUCATION

With respect to education quality, Honduras performs on par with comparator countries across most international measures of educational quality at the primary and lower secondary levels. This does not necessarily speak to the high quality of primary and lower secondary education in Honduras, but rather, the generally poor educational outcomes that are widespread across the Central American region. Honduran students across all income levels perform below internationally accepted standards for proficiency in mathematics and reading, according to the OECD PISA Assessment, which measures educational outcomes among 15-year-old students.¹³ However, as shown in the figures below, these scores do not differ significantly from scores in Guatemala or Paraguay (the only other two comparator countries that participate in PISA). Moreover, Honduran students perform better on the PISA in terms of equity: there is a smaller gap in PISA mathematics and reading scores between severely poor and non-poor students in Honduras than in either comparator country. While not displayed here, there are also no substantial differences in PISA scores between male and female students: while male students perform slightly better than female

⁸ World Bank (2019), "Nicaragua: Systematic Country Diagnostic"

⁹ NORAD and Norwegian Refugee Council (2019), "Una Generación Fuera de la Escuela: Educación en Honduras"

¹⁰ Melissa Adelman and Miguel Szekely (2016), "School Dropout in Central America: An Overview of Trends, Causes, Consequences, and Promising Interventions", World Bank

¹¹ Melissa Adelman and Miguel Szekely (2016)

¹² Marco Antonio Hernandez Ore, Lilliana D. Sousa, and J. Humberto Lopez (2015), "Honduras: Unlocking Economic Potential for Greater Opportunities", World Bank

¹³ OECD PISA scores are only available for Honduras, Guatemala, and Paraguay

students on mathematics, female students perform better than males on reading.

Figure 5-4: PISA Reading Scores by Household Poverty Level, 2015

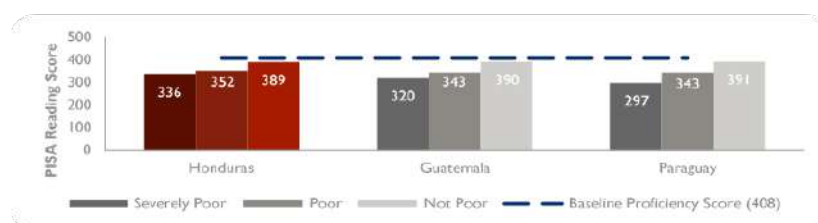
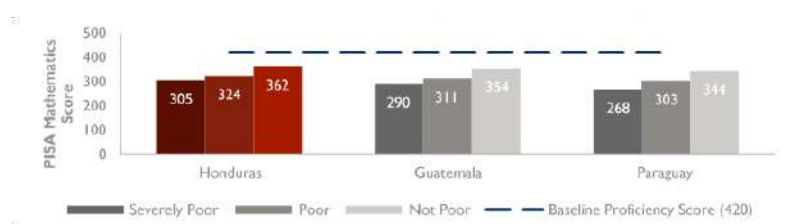


Figure 5-5: PISA Mathematics Scores by Household Poverty Level, 2015



Source: OECD PISA

5.3.2 TECHNICAL AND VOCATIONAL EDUCATION

Issues with quality and relevance in Honduras' education system begin to emerge more clearly at the technical and vocational levels. Technical and vocational education (TVET) is largely administered through the National Institute of Professional Training, or INFOP. INFOP was established in 1972 with the goal of providing professional training across all sectors aligned with Honduras' national development plans. Investments in INFOP are substantial, at US \$38 million in 2016.¹⁴ Funding largely comes from contributions from private sector firms with five or more employees through a one percent payroll tax.

At present, INFOP offers technical training in 118 different areas, with modalities ranging from online courses and short workshops to long-term courses lasting up to 2 years.¹⁵ However, in recent years, INFOP has come under significant criticism from the private sector over the relevancy and quality of the courses offered, with the Honduran Council of Private Enterprises (COHEP) recently calling on its members to withhold their contributions to the institute as a means to demand reform.¹⁶ Specifically, the private sector has expressed concerns that INFOP's courses rely heavily on outdated material, including curricula and course manuals that are up to 40 years old and often poorly aligned with present-day market needs.¹⁷ Moreover, INFOP does not currently have a system for tracking the number of trainees by course or the outcomes of trainings in terms of job placement or skills retention, reducing transparency and accountability, and hindering the organization's ability to continually improve and adapt its offerings.

5.4 LABOR MARKET OUTCOMES

5.4.1 UNEMPLOYMENT

The challenges with human capital in Honduras are extraordinarily complex and extend beyond issues with completion and quality. Although unemployment in Honduras is not particularly high

¹⁴ Veronica Michel and Ian Walker (2019), "Honduras Jobs Diagnostic", World Bank

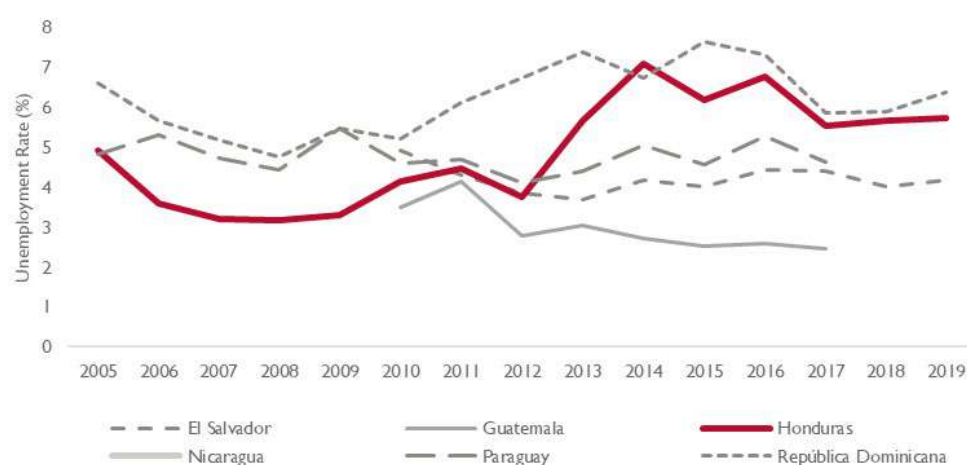
¹⁵ Ibid

¹⁶ Tiempo Web (May 13, 2019), "COHEP detendra contribuciones si INFOP no aplica reformas, informa Urtecho"

¹⁷ Veronica Michel and Ian Walker (2019), "Honduras Jobs Diagnostic"

relative to global standards, at 5.7 percent in 2019, it is slightly higher than comparator countries. Moreover, this figure belies wide variations in unemployment rates among women and youth, as well as urban versus rural residents.

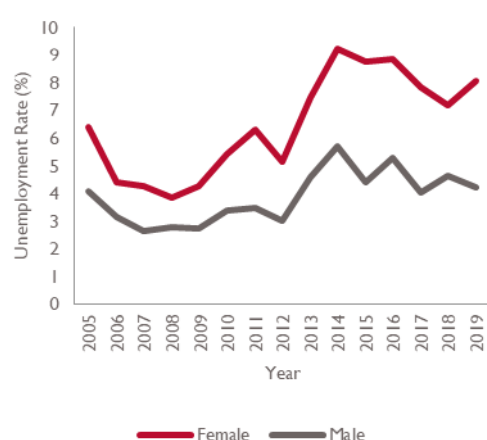
Figure 5-6: Unemployment Rates, Adults 15+ (2005-2019)



Source: World Bank World Development Indicators

There are significant disparities in unemployment rates between men and women in Honduras. As shown in the figure below, women experience twice the unemployment rate of men, at 8.1 percent in 2019 compared to 4.2 percent among men.

Figure 5-7: Unemployment Rates by Gender (2005 - 19)



Source: ILOSTAT

Perhaps more concerning, the gap in unemployment rates between men and women has widened significantly in recent years, suggesting that barriers to women's employment have worsened, even as women's educational attainment has generally improved. While this gap between male and female unemployment exists in most comparator countries (with the exception of El Salvador, where unemployment among men is slightly higher than among women), it is largest in Honduras.

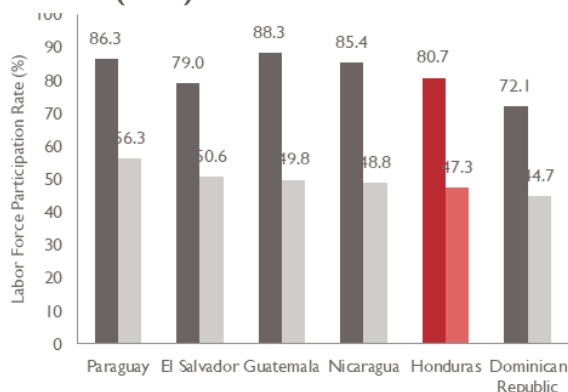
Youth unemployment presents another significant challenge to human capital in Honduras. While not the highest rate in the region, youth unemployment is high, at 10.9 percent in 2019.

5.4.2 LABOR FORCE PARTICIPATION

While Honduras' unemployment rates are relatively low compared to global averages, albeit slightly higher than regional comparators, labor force participation rates are among the lowest in the LAC region. As of 2020, 63.9 percent of the working age population participated in the labor force, placing Honduras behind Paraguay, Nicaragua, and Guatemala, and slightly higher than El Salvador and the Dominican Republic. Although this rate has improved steadily over the past decade from 60.7 percent in 2010, progress has stalled in recent years.

This challenge is particularly salient among women and youth. Overall, approximately one-quarter (24 percent) of youth in Honduras are classified as “NEETS”, or individuals who are neither studying, working, nor in training. Despite concerns that Honduras’ NEET population may be contributing to high levels of crime and gang violence in the country, most NEETs are young women, not men; overall, females comprise 88 percent of all NEETS in the country.¹⁸

Figure 5-8: Labor Force Participation by Gender (2020)

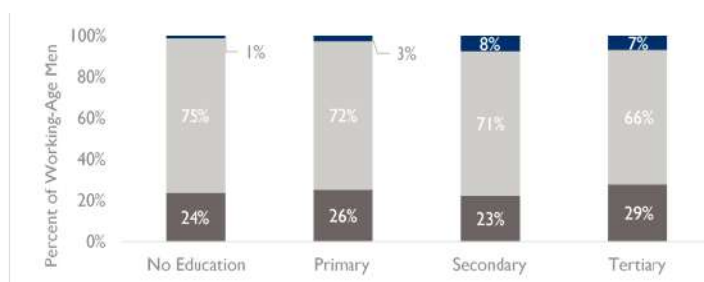


Source: ECLAC

More broadly, women of all ages report significantly lower labor force participation rates than men, despite having near equal levels of educational attainment. In 2020, just 47.3 percent of working-age women participated in the labor force, compared to 80.7 percent of men. While this is not the lowest female labor force

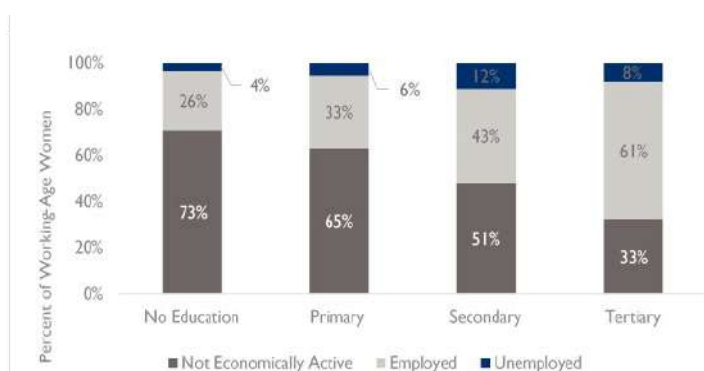
participation rate among comparator countries, it is among the lowest in the LAC region.

Figure 5-9: Labor Force Participation by Level of Education (Men)



Unlike male labor force participation, which is generally consistent across levels of education, women experience vastly different rates of labor force participation depending on their level of education. Most women with no education or a primary education do not participate in the labor force. Among women with a secondary education, over one-half (51%) do not participate in the labor force, compared with just 23 percent of men. At the tertiary level of education, labor force participation is slightly more equal between men and women; one-third of women (33 percent) do not participate in the labor force, compared to 29 percent of men.

Figure 5-10: Labor Force Participation by Level of Education (Women)



Source: EPHPM 2019

This data suggests that there may be social, cultural, or structural factors that prevent or

discourage women from seeking employment, even as these women attain higher levels of education. These themes were echoed in focus groups conducted with civil society leaders, private sector

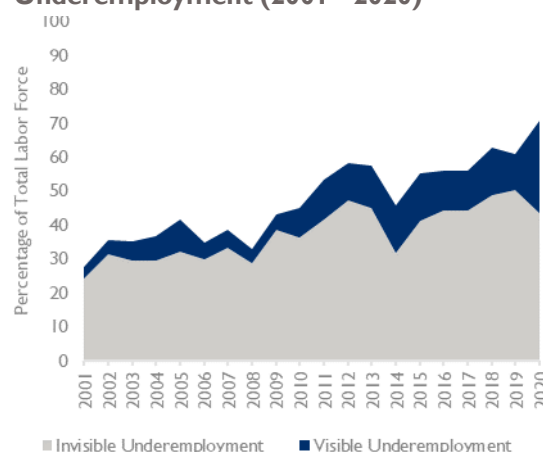
¹⁸Ibid

actors, and academics in Honduras, who cited gender-based discrimination and a higher caregiving burden (relative to men) as major factors constraining female labor force participation. Women in Honduras may also be constrained in their ability to access jobs with a sufficient degree of flexibility, security, and dignity, as these jobs are in short supply in the Honduran labor market. As the World Bank notes in their most recent Jobs Diagnostic report for Honduras, “Female education has run ahead of job creation in desirable areas for better-educated girls and women...The problem is [best] understood in terms of a mismatch between the quality of the emerging female workforce and the quality of jobs, including the degree of security and dignity associated with them.”¹⁹

5.4.3 UNDEREMPLOYMENT AND WAGES

Among Hondurans who do participate in the labor force, jobs are frequently low quality, and underemployment is a rising challenge. As of 2020, 71 percent of Hondurans report that they are underemployed. Most of this underemployment is “invisible”, meaning that workers report making less than the minimum wage. Overall, Honduras does have the highest average minimum wage rates in the region, and some of the sharp increases in invisible underemployment may be attributed to concurrent increases in the minimum wage during that time. For instance, in 2008, Honduras raised the minimum wage by approximately 40 percent, followed by a 32 percent increase in 2011.²⁰ During the same period, invisible underemployment rose from 28.8 percent in 2008 to 41.4 percent in 2011.

Figure 5-11: Visible and Invisible Underemployment (2001 - 2020)



Source: EPHPM 2019

More broadly, growth in Honduras’s minimum wage has continually outpaced real average wage growth, both in the formal and informal sector. As of 2020, Honduras’s average minimum monthly minimum wage has been set at 10,022 lempiras per month, or US\$415.²¹ By comparison, the average monthly wage of Honduran households during this same period was just 7,600 lempiras per month, or US\$315. According to analysis by the World Bank, this gap between the legal minimum wage and average wages, which has averaged approximately 30 percent since 2008, is the largest in the region.²²

At the same time, Honduras has seen an increase in the rate of visible underemployment - or employment situations in which an employee works less than 32 hours per week - since the onset of the global financial crisis in 2008 and Honduras’ political crisis in 2009. As noted in a 2018 report on underemployment from the National Autonomous University of Honduras (UNAH), this increase in visible underemployment can in part be attributed to short-term policies implemented during this period including the National Program of Hourly Employment. These policies fueled the creation of

¹⁹Ibid

²⁰Ibid

²¹ Economic Commission for Latin America and the Caribbean (2020), “Economic Survey of Latin America and the Caribbean: Honduras”

²² Veronica Michel and Ian Walker (2019), “Honduras Jobs Diagnostic”

temporary, low productivity employment opportunities which, while successful in reducing unemployment, increased the visible underemployment rate.²³

In both cases, the Honduran labor market appears to have lost its ability to absorb workers into the formal sector, spurring a deterioration in the quality of jobs available to workers. As such, despite substantial increases in the legal minimum wage, most workers continue to work in low productivity, low wage jobs that offer minimal opportunities for income mobility.

5.4.4 MIGRATION AND REMITTANCES

Given the low quality of jobs in Honduras, is it perhaps unsurprising that many Honduran households have become increasingly reliant upon migration and remittances. Migration from Honduras has increased rapidly over the past two decades. Between 1990 and 2015, the number of Honduran migrants living in the United States increased from 115,000 to 630,000.²⁴ Crucially, this figure likely underestimates the number of Honduran migrants living abroad, as a significant number are irregular migrants that are generally not captured in official statistics. In 2019, it was estimated that between 16 and 36 percent of the Northern Triangle’s “demographic dividend” population was living abroad, presenting a significant threat to the region’s economic growth prospects.²⁵

Contrary to popular belief, recent evidence suggests that migrants from Honduras are increasingly well-educated, suggesting that migration is not a phenomenon confined to the poorest of the poor. A survey conducted by the Inter-American Development Bank (IDB) found that 36 percent of irregular migrants traveling from Honduras to the United States had completed secondary school, compared with 22 percent of the Honduran population.²⁶ The vast majority of migrants (75%) cite economic reasons as their primary motivation for migration.²⁷ The economic returns to migration are substantial: analysis on U.S. Census data and household survey data from Honduras shows that wages for Central American migrants residing in the United States are 3.1 times higher than wages for individuals living in Honduras with a primary education, 2.3 times higher than individuals with a secondary education, and 2.3 times higher than individuals with a tertiary education.²⁸

Honduran households also experience the economic benefits of migration through another channel: remittances. Overall, Honduras has the highest level of remittance receipts as a percentage of GDP across all comparator countries. Households’ reliance on remittances as a source of income has also increased rapidly: recent analysis by the UNDP found that 54.7 percent of households report relying on remittances as their primary source of income.²⁹

²³ Henry Rodriguez Corea et al. (2018), “Situación del Empleo en Honduras, 2001-2018”, Universidad Nacional Autónoma de Honduras

²⁴ D’Vera Cohn, Jeffrey Passel, & Ana Gonzalez-Barrera (2017), “Rise in U.S. immigrants from El Salvador, Guatemala, and Honduras outpace growth elsewhere”, Pew Research Center

²⁵ Emmanuel Abuelafia, Giselle Del Carmen, & Marta Ruiz-Arranz (2019), “In the footprints of migrants: Perspectives and experiences of migrants from El Salvador, Guatemala, and Honduras to the United States”

²⁶ Ibid

²⁷ Ibid

²⁸ The average annual income for a Central American (non-Mexican) migrant with primary education in the U.S. was US\$15,526, US\$18,880 for someone with secondary education, and US\$37,225 for someone with tertiary education. By comparison, the average annual income for a household within Honduras is roughly US\$4,959 for someone with primary education, US\$8,235 for secondary education, and US\$15,862 for someone with tertiary education

²⁹ Andres Ham (2020), “Social and economic impacts of COVID-19 and policy options for Honduras”, United Nations Development Program

There is some evidence to suggest that these high levels of migration and remittance receipts are affecting the reservation wage of the labor force in Honduras. Regression analysis of Honduran household survey data from 2019 found that a 10-percentage point increase in remittance receipts was correlated with a 37-percentage point decrease in the likelihood that an individual would participate in the labor force. These findings are consistent with recent literature, which has generally concluded that remittance receipts lower labor force participation in the Northern Triangle.³⁰

There is also evidence to suggest that migration raises wages within the country. Analysis by the OECD found that increased migration from Honduras following Hurricane Mitch was associated with a 10 percent increase in average wages during the same time period.³¹ More recently, a 2020 survey of private business owners in Honduras found that the most commonly cited difficulty firms encountered in hiring workers was higher salary expectations than the firm could provide.³² Taken together, this evidence strongly suggests that remittances and migration have placed upward pressure on reservation wages in Honduras, creating a vicious cycle of low competitiveness, reduced labor supply, and low growth.

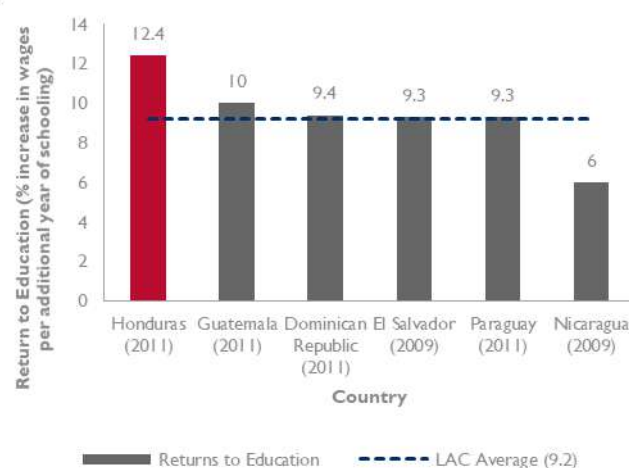
5.5 DIAGNOSTIC TESTS

To evaluate whether human capital is a binding constraint to growth, this analysis undertook three diagnostic tests.³³ The results of these tests are summarized below.

5.5.1 TEST 1: IS THE SHADOW PRICE OF THE CONSTRAINT HIGH?

If human capital is a constraint to growth in Honduras, we would expect the shadow price of the

Figure 5-12: Monetary Returns to Education



Source: Montenegro and Patrinos (2014)

constraint to be high. In this case, the shadow price can be defined as the monetary returns to education. If human capital is a constraint, we would expect to see high monetary returns to schooling, as the demand for educated workers outpaces the supply.

In the case of Honduras, we find that the returns to education are indeed extremely high. Data on internationally comparable estimates of the returns to education show that Honduras has higher monetary returns to education than any of the comparator countries, at 12.4 percentage points in increased wages per additional year of schooling. Analysis of more recent

wage data using household surveys finds a similar rate of return to education in 2019, at 12.9

³⁰ See, for example, Liliana D. Souza & Andres Garcia-Suaza (2018), "Remittances and Labor Supply in the Northern Triangle", World Bank

³¹ Jason Gagnon (2011), "Stay with us? The impact of emigration on wages in Honduras", OECD Development Center Working Papers

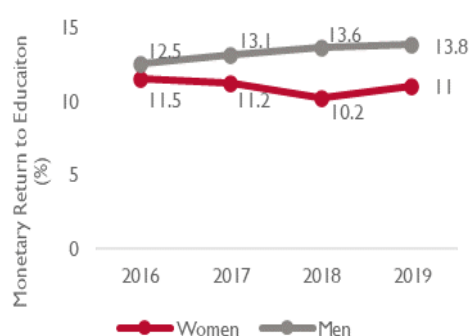
³² UNAH-IIES, COHEP, & USAID/Honduras (2020), "Honduras Market Systems Diagnostic"

³³ Test 2 (Impulse-Response) was not performed due to lack of sufficient data.

percentage points per additional year of education. These high returns provide compelling evidence that there is a low supply of educated workers relative to market demand.

However, these returns to education are not equally shared. Women experience substantially lower (albeit still high relative to regional averages) returns to education compared to men. Moreover, the gap in returns to education has widened between 2016 and 2019, suggesting that the barriers to women's full participation in the labor force and access to high quality jobs has worsened, rather than improved. Given that women have similar average educational outcomes to men, both in terms of completion and exam scores, these findings suggest that structural, social, or cultural factors may be at play in preventing women from reaping the full benefits of their education.

Figure 5-13: Monetary Returns to Education by Gender

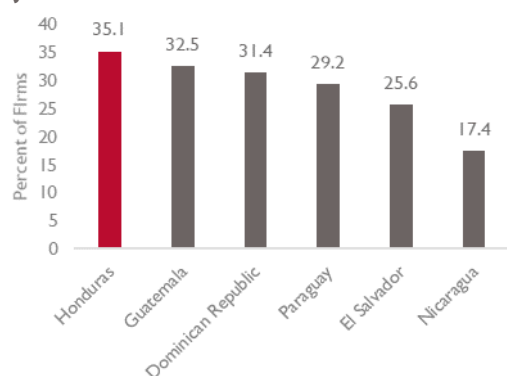


Source: EPHPM 2016-2019

5.5.2 TEST 3: DO WE OBSERVE INDIVIDUALS ATTEMPTING TO BYPASS THE CONSTRAINT?

If human capital is a constraint to growth, we should also observe individuals acknowledging and attempting to bypass the constraint. Results from the 2016 World Bank Enterprise survey show that private firms in Honduras do recognize human capital as a significant issue: Honduras has the highest percentage of firms who list “inadequately educated workforce” as a “major” or “severe” constraint to doing business among all comparator countries, at 35 percent.

Figure 5-14: Proportion of Firms Identifying Inadequately Educated Workforce as a Major Constraint



Source: World Bank Enterprise Survey

Firms appear to take a variety of measures to bypass this constraint. While the 2016 Enterprise Survey found that a substantial proportion (47 percent) of firms' report providing training to employees (placing Honduras in the middle of comparator countries), a more recent survey conducted in 2020 by the National Autonomous University of Honduras (UNAH) found that 76 percent of firms in Honduras provided some form of training to employees, which would place Honduras well above the comparator average. However, much of this training was focused on COVID-19 safety procedures.³⁴

That Honduras does not report a higher proportion of firms providing in-house training to employees is likely due to firms' reliance on the technical and vocational training provided through INFOP, which obtains the majority of its funding through private firm contributions. Indeed, while data on INFOP's trainees is limited, the data that is available suggests that many private firms do use INFOP in place of in-house training programs: just 11 percent of INFOP's existing programs are targeted towards labor market entrants, and the majority (87 percent) of trainees at INFOP are currently employed.³⁵ Although not specific to INFOP, the UNAH Market Systems survey found that 86 percent of firms in Honduras used external workforce training in the past year. Unfortunately, more detailed data on

³⁴ UNAH-IIES, COHEP, & USAID/Honduras (2021), “Honduras Market Systems Diagnostic”

³⁵ Veronica Michel and Ian Walker (2019), “Honduras Jobs Diagnostic”

the content of training demanded by employers is unavailable, and further study may be required to identify the specific skills that are currently in demand by the private sector.

Beyond training, there is some anecdotal evidence that firms may outsource certain high-skilled jobs to workers in other countries in the region such as Costa Rica and Nicaragua. However, due to data constraints, this phenomenon cannot be quantified.

5.5.3 TEST 4: DO FIRMS THAT ARE MORE HINDERED BY THE CONSTRAINT PERFORM WORSE THAN FIRMS THAT ARE LESS HINDERED BY THE CONSTRAINT?

Finally, if human capital is constraining economic growth in Honduras, we would expect to see evidence that firms requiring fewer workers or fewer skilled workers (i.e., less human capital intensive) performing better than firms that are more human capital intensive. For the purpose of this test, we examine growth in Honduras' high-tech exports sector as a proxy for human capital-intensive sectors writ large. As shown below, Honduras exports fewer high-tech goods as a percentage of GDP than would be expected for a country of its income level. Moreover, Honduras exports fewer high-tech goods as a percentage of all manufactured exports than all comparator countries, with the exception of Nicaragua. While there are many economic factors that may contribute towards a country's export basket, the evidence suggests that Honduras' low human capital endowment may be constraining growth in human capital-intensive industries.

6 MACROECONOMIC RISKS

Macroeconomic risks can present a binding constraint to growth when they substantially reduce the ability of private businesses to appropriate returns on their investments. This could occur through two channels: either current situations and policies, or the expectation of future risks. The former is more straightforward: poor macroeconomic management could result in the de facto expropriation of investment returns through inflation, a public debt default, a financial sector crisis, or the collapse of an artificially overvalued exchange rate, among other scenarios. Similarly, the mere expectation of such risks occurring in the future could be enough to deter investors from beginning new ventures or expanding existing ones, given lower expected future returns.

There are few indications that the macroeconomic environment in Honduras is a binding constraint to growth. While there are only several formal growth diagnostic tests performed in this chapter, the overall health of macroeconomic indicators is clear: despite shocks resulting from the spread of and containment measures for COVID-19 in 2020, fiscal and monetary policies as well as external sector issues appear to be relatively well-managed. Relative to its comparators, the Honduran government's fiscal deficit is small, government debt increased but not dramatically, inflation and exchange rate volatility remained low, foreign reserves are sufficient, and remittances proved resilient to the pandemic. In addition to these across-the-board positive benchmarking results, all formal growth diagnostic tests run in this chapter indicate that macroeconomic risks are not a binding constraint to growth.

6.1 FISCAL POLICY

Like countries around the world, Honduras was exposed to severe fiscal shocks resulting from the spread of and containment measures for COVID-19 in 2020. Government revenues fell with the decline in economic activity, while expenditures ramped up to address the health and economic implications of the pandemic and the aftermath of hurricanes Eta and Iota. While some are concerned that these factors in combination with the political pressures of an election year will compromise fiscal sustainability in 2021 (EIU 2020), the IMF has continued to view the medium-term fiscal outlook favorably given the Honduran government's commitment to maintaining its fiscal credibility (IMF 2020, p. 10). Further, for the purposes of this growth diagnostic, we are concerned with current binding constraints, not with the possibility that something may become a constraint in the future.

As of 2020, government revenues are higher as a percentage of GDP than all comparators but Nicaragua (Figure 6-1). Revenues have remained stable at 30-32 percent of GDP since 2013, with taxes increasing from roughly 50 percent to 60 percent of all revenues, 2020 notwithstanding. Taxes on goods and services represent the largest portion of tax collection, while income tax collection increased steadily from 5.2 percent of GDP in 2013 to 6.3 percent in 2018, before dropping off again beginning in 2019 (Figure 6-2)

Figure 6-1: Government Revenues (General Government)

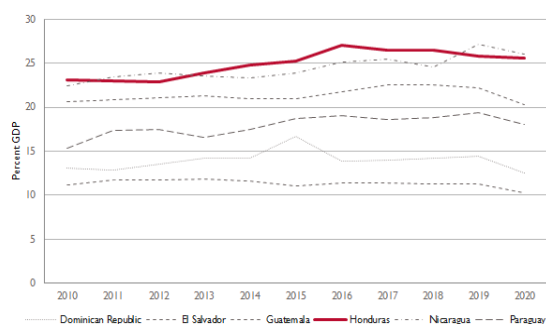
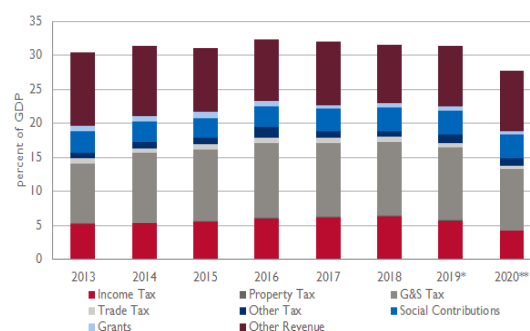


Figure 6-2: Government Revenue (Nonfinancial Public Sector)



Sources: 6.1 - IMF, *World Economic Outlook* (October 2020). 5.2 - IMF, *Various Documents* (2016, 2018, 2019 Article IV Reports, Dec. 2020 SBA/SCF 3rd Review), Statement of Operations of the Nonfinancial Public Sector.

Note: Total do not align due to differences in definitions of general government and nonfinancial public sector.

*Preliminary **Projected

Meanwhile, government expenditures have been high but stable, with a decreasing share going toward wages. Government expenditures (nonfinancial public sector, which includes autonomous state-owned enterprises) have stabilized around 32 percent of GDP in recent years, down from 38 percent in 2013 when fiscal consolidation (i.e., debt and deficit reduction) began. Employee compensation has declined from 14 percent of GDP in 2013 to 11-12 percent, and goods and services purchase are also slightly down. Social benefits have increased marginally, up from an average of 3.4 percent of GDP (2013-2014) to 3.9 percent over 2015-2020.

Figure 6-3: Government Expenditures (General Government)

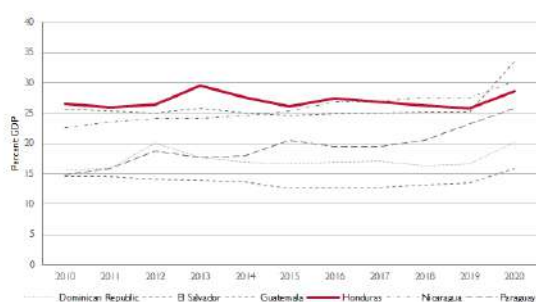
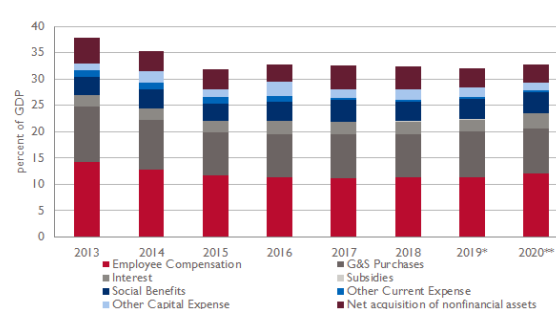


Figure 6-4: Government Expenditures (Nonfinancial Public Sector)



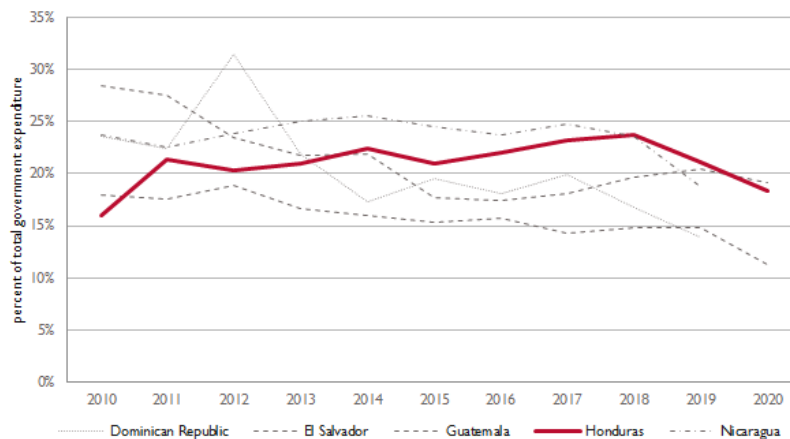
Sources: 5.3 - IMF, *World Economic Outlook* (October 2020). 5.4 - IMF, *Various Documents* (2016, 2018, 2019 Article IV Reports, Dec. 2020 SBA/SCF 3rd Review), Statement of Operations of the Nonfinancial Public Sector.

Note: Total do not align due to differences in definitions of general government and nonfinancial public sector.

*Preliminary **Projected

During the preparation of this study, several stakeholders indicated concern that the government was underspending on longer-term investment and overspending on current expenditures, such as the wages of public sector workers. However, Honduras appears to have one of the higher ratios of capital expenditures as a percentage of total government expenditures among comparators (Figure 6-5). This bodes well for future growth prospects, as productivity-enhancing capital expenditures like infrastructure can increase potential growth.

Figure 6-5: Capital Expenditure (% of government expenditure)



Source: Consejo Monetario Centroamericano (SECMCA)

6.1.1 PUBLIC DEBT, TEST 2: DO MOVEMENTS IN THE CONSTRAINT PRODUCE SIGNIFICANT MOVEMENTS IN THE OBJECTIVE FUNCTION?

Overly expansionary fiscal policy, like tax cuts or increases in government spending, can lead to rising debt levels. Excessive debt levels, in turn, can lead to a variety of negative outcomes: inflation, default, and the inability of the private sector access credit, to name a few. As such, here we test whether public debt is correlated with GDP growth. Using annual data from 2000-2020 for debt as a percent of GDP and GDP growth, we find a Pearson correlation coefficient of 0.18, indicating that there is no strong relationship between these two variables. This is the expected result if fiscal policy is not a constraint on economic growth. It is also consistent with the IMF's July 2019 assessment that the overall risk of debt distress in Honduras is low (IMF & IDA 2019), an assessment that has not been revised due to COVID-19 (IMF 2020, p. 15).

6.2 MONETARY POLICY

Monetary policy plays a central role in effectively managing macroeconomic variables like inflation, the exchange rate, and foreign reserves. Improperly managed monetary policy could result in expropriation of profits from the private sector and rising costs for households. In Honduras, the Banco Central de Honduras is the monetary policy-making institution.

Similar to overall macroeconomic risks, inflation can lower returns to an investment by reducing the ability of firms to internalize their returns. More specifically, price volatility or significant increases in the price level can raise the cost of inputs for producers and reduce the purchasing power of consumers. Conversely, deflation can cause consumers to wait for future lower prices, reducing economic activity. As such, most central banks around the world target low and stable levels of inflation. Here, Honduras is in line with the international norm, targeting an inflation range of 3 to 5 percent annually as seen in Figure 6-8 below.

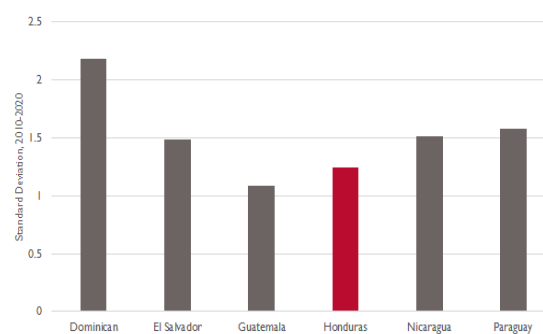
While consumer price inflation is on the higher end among comparators, it has remained relatively stable (Figure 6-6). This stability can also be seen in the low year-to-year volatility of inflation, which was the second lowest among comparators over the past decade (Figure 6-7). However, this aggregate inflation level disguises several interesting underlying trends, particularly as they relate to the response to COVID-19. With the COVID-19 shock in 2020, different categories of goods and services experienced varied price trajectories, ranging from severe price volatility for transportation,

a rapid price increase in healthcare, a slowdown in the speed of price increase for education, or a gradual price decrease in communication (Figure 6-8).

Figure 6-6: Consumer Price Inflation

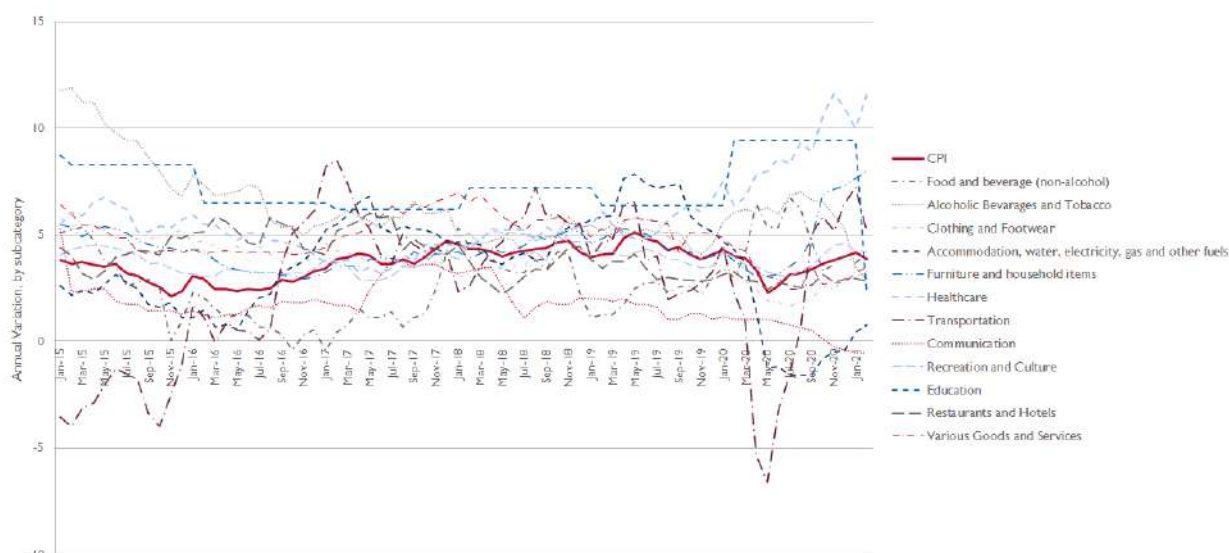


Figure 6-7: Inflation Volatility



Source: IMF, *World Economic Outlook* (October 2020)

Figure 6-8: Inflation (Annual Variation) by Group of Goods & Services



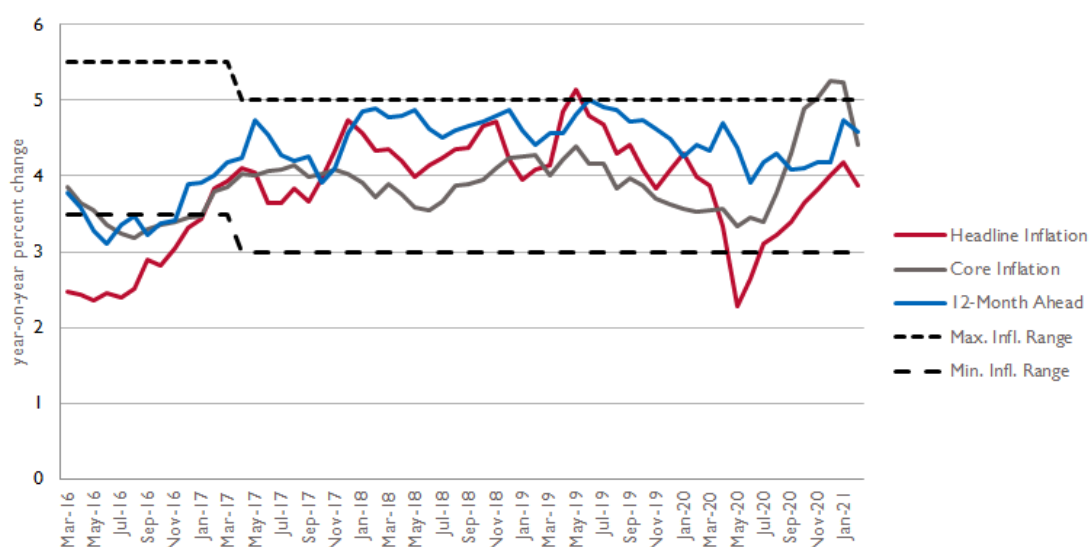
Source: Banco Central de Honduras (BCH), Consejo Monetario Centroamericano (SECMCA)

Note: The consumer price index (CPI) market basket of goods and services has not been updated by the BCH since 1999.

6.2.1 INFLATION, TEST 1: IS THE SHADOW PRICE OF THE CONSTRAINT HIGH?

To test whether the shadow price of the constraint is high, inflation (in this case, the shadow price) is evaluated against the Central Bank's own inflation targets. If the Central Bank were overshooting its inflation targets, it would be an indication that monetary policy was being improperly managed, causing issues for private sector investment. Instead, we see that the Central Bank has been able to reliably maintain three different measures of inflation within its 3 to 5 percent target range, with very few minor exceptions (Figure 6-9). Together with the benchmarking data on inflation volatility, this indicates that monetary policy is not a constraint on growth.

Figure 6-9: Inflation and Inflation Expectations in Honduras, with Central Bank Target Range



Source: Banco Central de Honduras

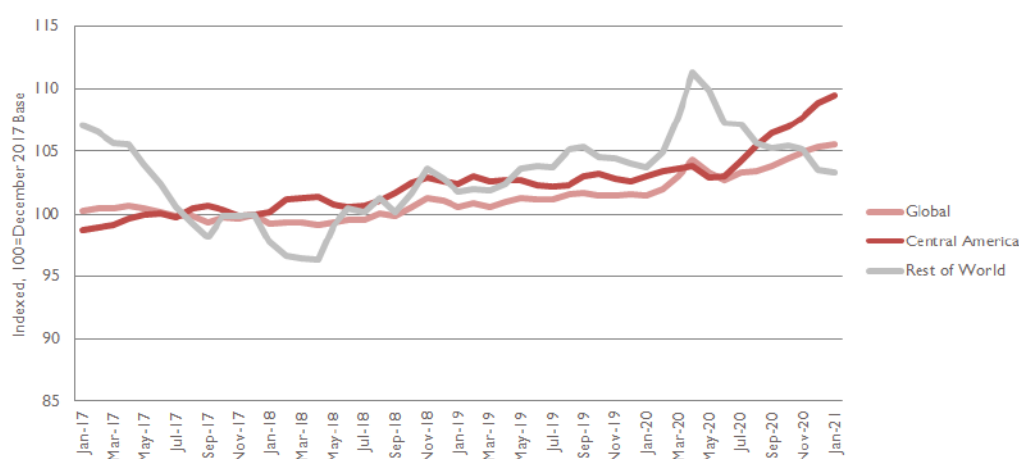
6.2.2 INFLATION, TEST 2: DO MOVEMENTS IN THE CONSTRAINT PRODUCE SIGNIFICANT MOVEMENTS IN THE OBJECTIVE FUNCTION?

To test whether monetary policy is restricting economic growth, we examine the correlation between inflation and GDP growth. If inflation is a binding constraint, we would expect to see a strong negative correlation between inflation and growth. Instead, using annual data from 2000-2020, we find a Pearson correlation coefficient of 0.41, indicating that there is instead a moderate positive correlation between the two variables, providing further evidence that monetary policy is not a binding constraint.

6.2.3 EXCHANGE RATE, TEST 1: IS THE SHADOW PRICE OF THE CONSTRAINT HIGH?

Another aspect of monetary policy is the exchange rate. If monetary policy were a binding constraint, we would expect to see issues with the exchange rate (in this case, the “shadow price”), such as rapid depreciation, significant volatility, or persistent overvaluation supported by the depletion of reserves. Although the exchange rate has been gradually depreciating over the past several years (Figure 6-10, light red line), it appreciated slightly relative to the U.S. dollar through 2020. As such, this test provides further confirmation that monetary policy is not a binding constraint on growth. Overall, the IMF has judged the monetary policy stance of the Central Bank to be accommodative and is supporting efforts for a transition to a more flexible exchange rate regime (IMF 2020, pp. 14, 21).

Figure 6-10: Real Effective Exchange Rate Index



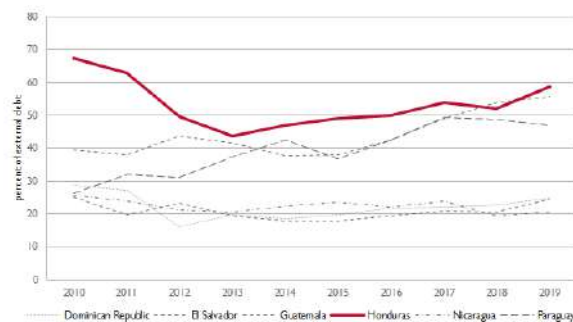
Source: Banco Central de Honduras, Índice del tipo de cambio effective real, January 2021.

In small open economies, foreign reserves are essential for managing macroeconomic risks, including the exchange rate, external debt, and the current account. Relative to comparators, Honduras entered 2020 with an enviable reserve position, providing a critical buffer against the COVID-19 shock. Measured both in months of imports (over 5) and as a percent of external debt (nearly 60 percent, higher than all comparators), reserves have grown considerably since 2012/2013. Despite the pandemic, the IMF projected some additional reserve accumulation in 2020 (IMF 2020, p. 20). This continued reserve accumulation indicates that reserves are not being used excessively to prop up or manipulate the exchange rate.

Figure 6-11: Total Reserves, in months of imports



Figure 6-12: Total Reserves, as a % of external debt



Source: World Bank, World Development Indicators

6.3 EXTERNAL SECTOR ISSUES

Honduras has run a consistent current account deficit for decades, meaning that broadly it spends more money on imports than it makes from exports or remittances. Between 2014 and 2019, the deficit averaged -3.9 percent (Figure 6-13), the second largest among comparators, though it has narrowed in recent years and totaled just -1.4 percent of GDP in 2019. The current account was projected to narrow further in 2020, with improved terms of trade from higher coffee prices and lower oil prices along with the impressive resilience of remittances (IMF 2020, p. 20). Overall, however, trade has proven a net negative for the current account due to the export underperformance described in the economic growth overview and market failures chapters.

Figure 6-13: Current Account Deficit, 6-year Average (2014 - 2019)

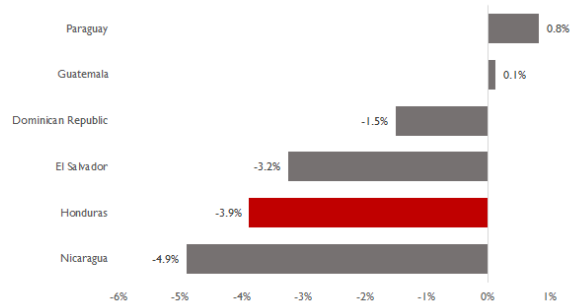
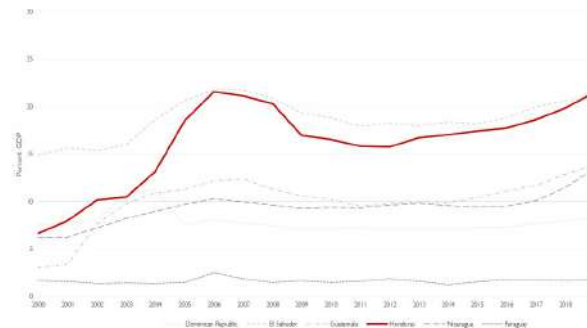


Figure 6-14: Personal Remittances Received, percent of GDP



Source: World Bank, World Development Indicators

Despite declining and relatively undiversified exports, the current account deficit has remained manageable due to one factor: remittances. Private household remittances are extremely high and cover a substantial portion of the current account deficit. Equaling 22 percent of GDP in 2019 (Figure 6-14), remittance receipts in Honduras are not only higher than receipts in all other comparators but represent the sixth-highest level in the world (World Bank, WDI). Of particular importance to the non-bindingness of the external sector, remittances appear to be resilient to shocks, lessening the risk of relying so heavily on this source of foreign exchange. When COVID-19 shutdowns were enacted in the United States and other destination countries for Honduran migrants, stifling service sectors in those countries, remittances predictably dropped off sharply in March and April 2020. However, they also recovered very quickly through summer and fall and reached record levels by March 2021 (IMF 2020, pp. 5, 20 and Banco Central de Honduras, Balanza Cambiaria).

7 MICROECONOMIC RISKS

The presence of microeconomic risks can cause low levels of demand for private investment in an economy. Microeconomic risks are a type of government failure that occurs at the firm-level, wherein economic actors are unable to appropriate a large enough share of the benefits created by their economic activities to make them worth engaging in in the first place. Microeconomic risks encompass several different aspects of the business environment, including the business enabling environment, access to land, and crime and security.

There is strong evidence that two microeconomic risks are binding constraints to growth in Honduras: 1) crime and insecurity, and 2) a burdensome regulatory environment resulting in high administrative costs to businesses. This chapter provides a brief benchmarking overview of both constraints, outlines the four diagnostic tests as they were applied to each constraint, and briefly discusses the inclusivity implications associated with each. It then closes with a brief discussion of non-binding microeconomic constraints and the evidence used to reach these conclusions.

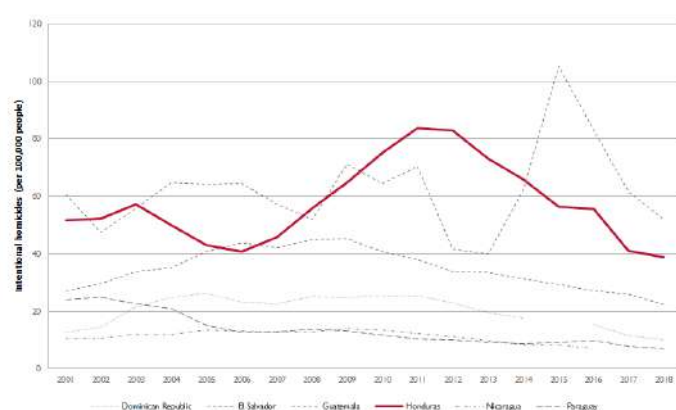
7.1 CRIME AND SECURITY

The presence of endemic crime and security concerns are a significant drain on a country's business environment. Insecurity and crime increase the risks and costs borne by firms and limits their economic returns. Crime and insecurity are a binding constraint to growth in Honduras. Its shadow price is high, and there is clear evidence that firms impacted by the constraint are less able to survive and thrive. Though the bypassing and impulse-response tests offer slightly less clear-cut evidence, they are still broadly suggestive of crime and insecurity as a binding constraint.

7.1.1 BENCHMARKING EXERCISE

Before applying the four diagnostic tests, we engage in a benchmarking exercise to determine how Honduras performs against its comparator countries. Broadly speaking, Honduras is one of the most violent countries in Latin America and performs poorly relative to comparator countries in most crime and security metrics and indices consistently over the last decade. This is particularly noteworthy given the severe, endemic crime and security challenges in Latin America.

Figure 7-1: Intentional Homicides in Honduras and Comparator Countries

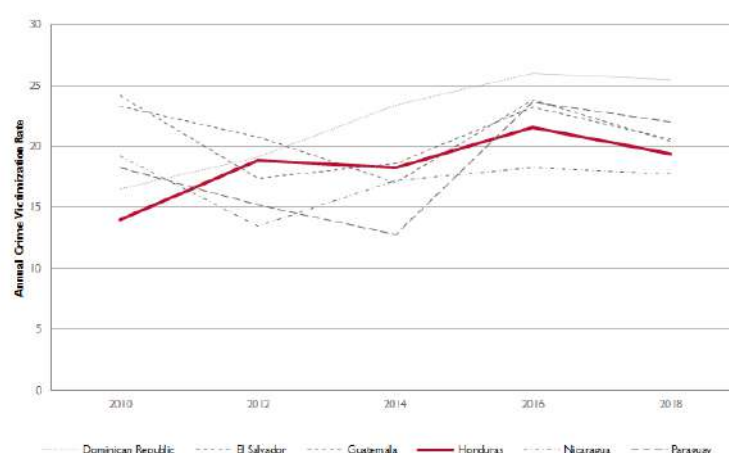


Though down from a peak high of almost 84 intentional homicides per 100,000 people in 2011, violent crime in Honduras remains high. Despite this improvement, it still has the second highest intentional homicide rate of comparator countries, trailing only El Salvador. As of 2018, the most recent year of data available from the World Bank's World Development Indicators, Honduras' intentional homicide rate per 100,000 is 39, the fifth highest in the world.

Figure 7-2: Crime Victimization Rates in Honduras and Comparators

In addition to high levels of homicides, Honduras also faces challenges related to broader types of crime, including robbery, burglary, assault, blackmail, fraud, extortion, and violent threats. Approximately 1 in 5 Hondurans are victims of crime annually, according to the Latin America Public Opinion Project (LAPOP) Americas Barometer Survey.

Though its crime victimization rate is more in line with comparator countries than its rate of intentional homicides, Honduras' crime rate has been trending higher since 2010, the first year for which data is available.



Often a simple benchmark against comparators suffices to place a country of interest in proper context. However, in the case of Honduras, its comparators, and crime and security, taking a more global perspective is illuminating. While violent crime has improved in Honduras, and its crime victimization rates are typical of its comparator countries, a look at global rankings of crime and security highlights the challenging neighborhood these countries find themselves in. The idea of Honduras being average among similar countries is less important when all countries being compared are particularly encumbered by a potential constraint, in this case crime and security.

Table 7-1: Honduran Crime and Security Rankings in Global Context

HONDURAS GLOBAL COMPETITIVENESS RANKINGS	2019 RANKING, OUT OF 141 COUNTRIES	2009 RANKING, OUT OF 133 COUNTRIES
Overall Security Index	137th	N/A
Organized Crime Sub-Index	136th	124th
Homicide Rate	138th	N/A
Reliability of Police Service Sub-Index	124th	111th
Business costs of crime and violence	N/A	123rd

Source: World Economic Forum

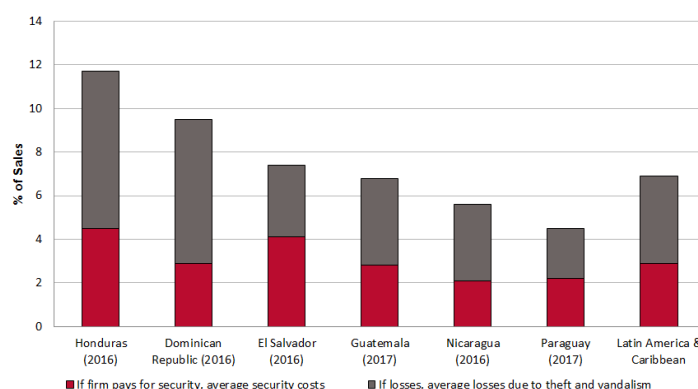
For over a decade, the World Economic Forum's Global Competitiveness Report has reported on crime and security as it pertains to countries' overall business climate. Table 7-1 puts Honduras' crime and security challenges in a global context. Though the specific indices included have changed over time, each sub-index has Honduras ranked as one of the worst performing countries globally, a position that has remained stable over time, with Honduras poorly ranked in both 2019 and 2009.

Now that Honduras' broad position among comparator countries has been established, we turn our attention to the application of the four diagnostic tests.

7.1.2 TEST 1: THE SHADOW PRICE OF CRIME AND SECURITY

If crime and security are a binding constraint, then the costs borne by individual firms and the broader economy because of these challenges would be high. We find this to be the case at both the micro- and macro-level in Honduras.

Figure 7-3: Firm-Level Crime and Security Costs in Honduras and Comparators

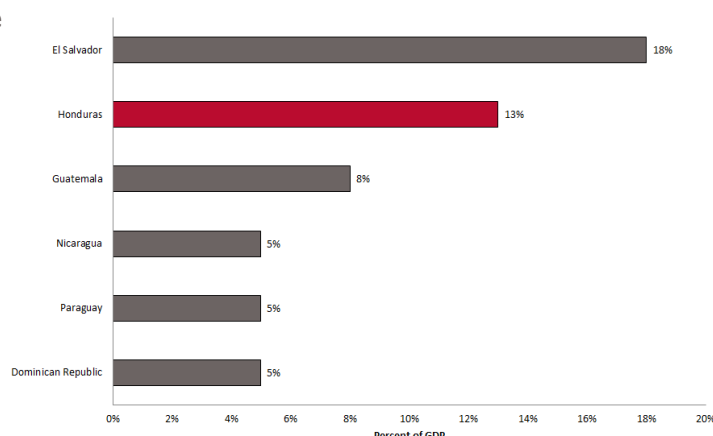


Honduran firms bear significant security costs and losses due to theft and vandalism. According to its most recent World Bank Enterprise Survey, in Honduras, the combined costs of both private security and losses suffered due to theft and vandalism is 11.7 percent of total sales. Note that this includes only the direct costs of crime and insecurity. These costs would be higher if the indirect costs,

such as firms unable to expand operations into high crime areas, were included. Nevertheless, these direct costs alone are higher both by component and in sum than in all comparator countries and the LAC average, suggesting that Honduran firms pay a large shadow price for the high levels of crime and poor security environment in which they operate.

Figure 7-4: Economic Impact of Violence and Conflict on Honduras and Comparators

As these firm-level costs of poor crime and security aggregate, they result in a significant cost to the aggregate Honduran economy. Numerous studies over the years have attempted to quantify the aggregate impact of crime and insecurity on Honduras' economy (Plotnikov 2020, IDB 2017), each showing a significant cost to overall GDP growth rates and levels that have persisted across time. As shown in Figure 7.4, using the most recently available 2019 data from the Institute of



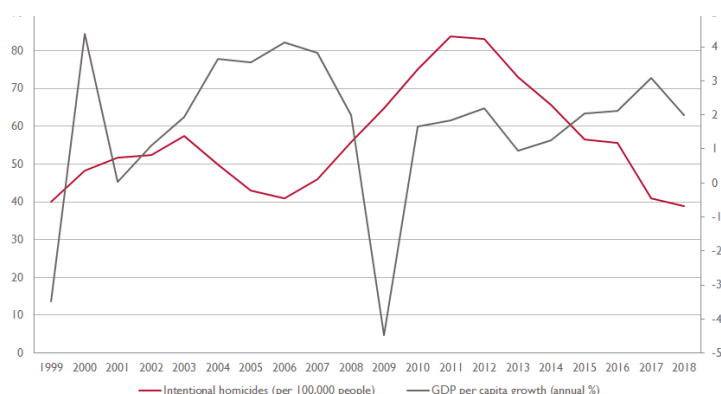
Economics and Peace, the impact of crime and violence levies a cost on the Honduran economy equivalent to 13 percent of GDP. This is the 20th highest globally and second only to El Salvador among comparator countries. Furthermore, this is likely an underestimation of the true economic cost of crime in Honduras given that it focuses on only violence and conflict and not on other types of non-violent crime.

Taken together, both measures demonstrate a high shadow price for crime and insecurity in Honduras relative to its comparator countries, suggesting the presence of a binding constraint. Given that all comparator countries operate in a challenging security environment, the fact that Honduras stands out among them is particularly compelling evidence of crime and security as a constraint.

7.1.3 TEST 2: RELATIONSHIP BETWEEN CRIME AND SECURITY AND AGGREGATE ECONOMIC PERFORMANCE

If crime and security are a constraint, then significant changes in the crime and security environment should result in a visible change in key economic performance indicators, such as GDP growth or private investment levels. In the case of Honduras, evidence for this test is less clear cut, though there does appear to be a negative correlation between crime and security and GDP per capita

Figure 7-5: GDP per capita and intentional homicides in Honduras, 1999-2018



According to the impulse-response diagnostic test, a natural experiment involving the sharp change in status of a binding constraint should have a visible effect on a country's growth at the macro level. The change in homicide rate between 2006 and 2018 highlighted earlier in the chapter provides such a natural experiment. Figure 7.5 overlays

Honduras' intentional homicide rate with its annual per capita GDP growth rate from 1999 to 2018. Though the presence of the global recession in 2009 is an obvious confounding variable during this timeframe, a visual examination does suggest that (outside of 2009) GDP per capita growth appears to be higher during periods with lower intentional homicide rates, such as between 2003 and 2008 and from 2013 to 2018.

We undertook a more quantitative examination of this relationship by analyzing a scatterplot of the post-2009 data included in Figure 6.4, which indicates a negative correlation and an R^2 of 0.25. This does not contradict the expected inverse relationship between levels of violence crime and rates of GDP growth.

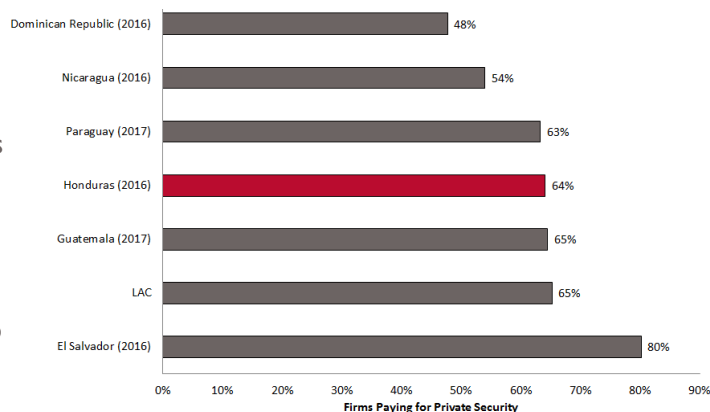
The evidence that crime and insecurity is a binding constraint presented in support of Test 2 is less clear-cut than that in support of Test 1. While economic performance in Honduras is moderately negatively correlated with violent crime, the 2009 global economic recession confounds the natural experiment of Honduras' increasing violent crime rate over the period in question, allowing us only to demonstrate a broader negative correlation between the two variables. However, despite this, the evidence presented in this subsection certainly does not suggest that crime and security is *not* a constraint, especially when positioned alongside the entirety of the other evidence available.

7.1.4 TEST 3: ATTEMPTS TO BYPASS CRIME AND SECURITY CHALLENGES

If crime and insecurity are a binding constraint to growth in Honduras, actors in the economy will take actions meant to bypass or mitigate their effects. In Honduras, we find evidence that economic actors are attempting to bypass a crime and insecurity constraint, though only some of these actions are occurring at rates higher than comparator countries. In some instances, the behavior of firms in Honduras are in line with the firms in comparator countries.

Figure 7-6: Private Security Usage by Honduran and Comparator Firms

According to the most recent World Bank Enterprise Surveys, Honduran firms use private security at similar rates as firms in comparator countries and in line with the Latin America & Caribbean average. Though these are high usage rates overall, and greater than the global average, it suggests that Honduras firms are attempting to circumvent a crime or insecurity constraint at a similar rate as other countries in the region. However, as noted previously, this “average” rate of private security usage is occurring in the midst of a region and comparator countries that also have high levels of crime and violence, suggesting that Honduras, comparators, and the region are all making serious efforts to bypass a crime and security constraint



While the rates of private security use are similar in Honduras and comparator countries, the number of private security personnel employed in Honduras is high, particularly compared with the total number of police officers. According to a 2018 report from the Inter-American Dialogue, “While private security guards outnumber police officers around the world, the gap is far larger in Latin America. In Brazil, the ratio is four to one, in Guatemala, five to one, and in Honduras there are almost seven private guards for every public officer.” A 2017 study by the Guardian using slightly more dated information also supports this conclusion, noting that by their calculation, Honduras’ ratio of private security personnel to police officers (approximately 5:1) is substantially higher than that of all comparator countries, with the exception of Guatemala (approximately 10:1). This use of private security has exploded over time, with the report noting that the private security industry in-country has grown “from 116 registered companies in 2007, to over 700 by 2013, 18 to 1,038 in 2017.”

This data presents stronger evidence of the severity of the crime and security challenge relative to comparators; though firms in Honduras and comparators utilize private security at similar rates, the ratio of private security to police in Honduras suggests that firms are utilizing them at higher rates, a finding suggested by the relatively high private security costs highlighted earlier in the chapter.

7.1.5 TEST 4: DIFFERENTIAL FIRM PERFORMANCE IN THE PRESENCE OF CRIME AND INSECURITY

If crime and security are a constraint, then firms that are relatively less impacted by poor security conditions are more likely to stay in business and grow compared to those whose business is more linked to a secure, low-crime business environment. In Honduras, the evidence strongly suggests that this is the case. Firms less hampered by the crime and security constraint appear to survive and thrive relative to firms that are more impacted by the constraint.

According to the most recent firm-level World Bank Enterprise Surveys, crime has a differential impact on firm performance across the Honduran manufacturing and service sectors. In Honduras, firms in the service sector are more heavily impacted by crime than manufacturing firms. They employ private security, experience greater losses due to theft and vandalism, and identify crime, theft, and disorder as a major constraint at a significantly higher rate. In addition to a significant differential between how manufacturing and services firms are impacted by crime and insecurity, there is a similarly large gap in performance: firms in the services sector have lower annual sales,

employment, and labor productivity growth than firms in the manufacturing sector, suggesting that firms less impacted by the crime and security constraint are more likely to survive and thrive.

Figure 7-7: Insecurity Impact by Firm Type

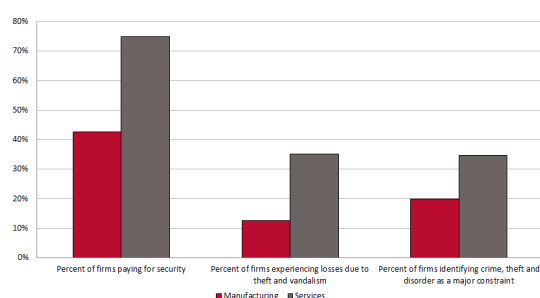
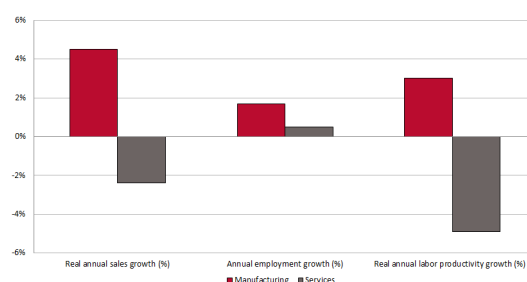


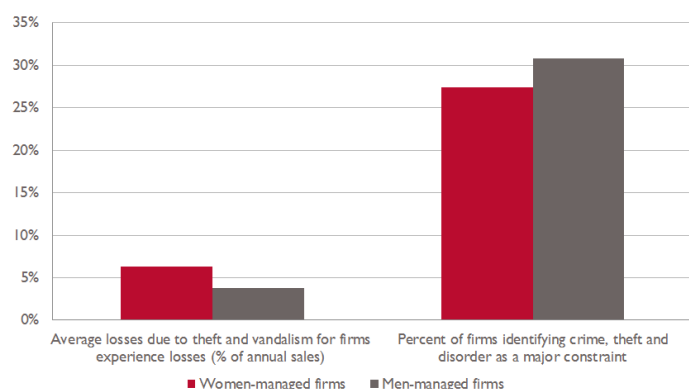
Figure 7-8: Performance by Firm Type



7.1.6 CRIME, SECURITY, AND INCLUSIVITY

Crime and insecurity can have a differential effect on marginalized groups like women, youth, and the poor. We include a brief summary of some of these impacts in this section, focusing first on the impact of crime and security on small and medium enterprises and those operated by women managers. We then highlight noteworthy differential impacts of crime and security on broader society, particularly related to gender-based violence and femicide, and close with a brief discussion of the impact of the COVID-19 pandemic.

Figure 7-9: Crime and Insecurity Impacts and Perceptions by Gender of Firm Manager

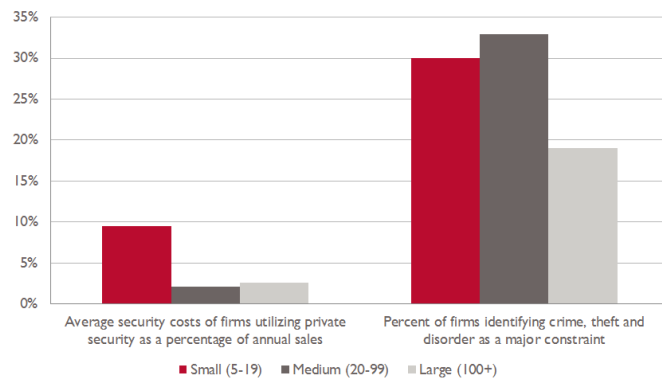


Crime has differential impacts across firm types, highlighting several inclusivity concerns. Based on the most recent firm-level World Bank Enterprise surveys, women-operated firms appear to be impacted by some aspects of crime and insecurity problems differently than those operated by men. While across many measures there do not appear to be gender-based differences, average security costs are almost

twice as high for women-managed firms (6.7 percent of sales) versus those managed by men (3.8 percent), with female-managed firms also somewhat less likely to pay for private security services (54 percent of firms versus 68 percent of firms managed by men). Yet, despite women-managed firms bearing greater costs of crime, the percentage of firms identifying crime, theft, and disorder to be a major constraint was gender neutral: 27 percent of women-managed firms versus 31 percent of those managed by men.

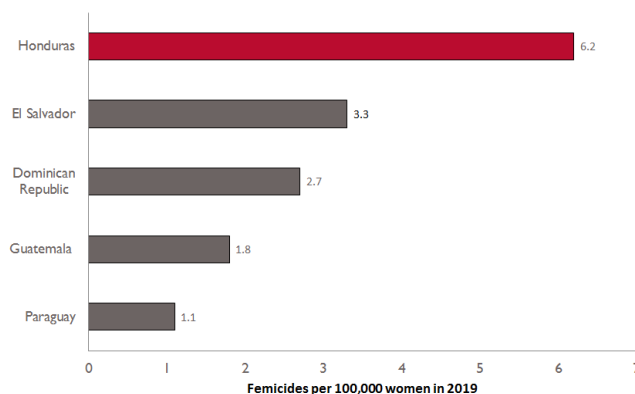
Figure 7-11: Crime and Insecurity Impacts and Perceptions by Firm Size

Shifting to an examination based on firm size, a similar pattern occurs. While across many measures, SMEs and large firms are impacted by crime and insecurity at similar rates, in some areas there are divergences. For example, average losses from theft and vandalism are 4 times higher for small firms than for medium or large firms, and small firms are much less likely to pay for security services



than medium or large firms (53.7 percent versus 88.2 and 93.7 percent, respectively). However, similar to women-owned firms, the percentage of small firms identifying crime, theft, and disorder as a major constraint (30 percent) is not overwhelmingly different from medium-sized firms (33 percent), though both do so at a higher rate than large firms (only 19 percent).

Figure 7-10: Femicide in Honduras and Comparators



In addition to micro impacts at the firm level, crime and insecurity has broader societal impacts as well. While women experience gender-based violence at rates similar to comparators, the femicide rate is the highest in the region. Several organizations quantify and track gender-based and intimate partner violence, including the WHO and the WEF as part of its Global Gender Gap Report. Across this internationally comparable data, Honduras' rates of these types of violence

are in line with comparator countries. However, Honduras surpasses all comparator countries and countries in the region (with available data from the UN's Economic Commission for Latin America) in femicides, with 6.2 per 100,000 women, almost double El Salvador's second-highest rate of 3.3 per 100,000 women.

While concern has been raised globally regarding increased levels of domestic violence during the COVID-19 pandemic and its associated lockdown measures, a recent UN analysis of domestic violence cases in Honduras during the first four months of 2020 suggest that during this time the number domestic violence cases did not change significantly before and after COVID-19-related lockdowns.

7.2 BURDENSOME REGULATORY ENVIRONMENT

A challenging regulatory environment can make a country a difficult place to do business and can discourage firms and entrepreneurs from engaging in economic activity altogether, expanding their existing businesses, or entering the formal economy. High administrative costs that result from a burdensome regulatory environment are a binding constraint to growth in Honduras. These regulatory challenges manifest themselves across a variety of areas where businesses must interact

with the state, including tax administration, starting businesses, and certain labor regulations and trade policy.

7.2.1 BENCHMARKING EXERCISE

Before applying the four diagnostic tests, we first engage in a benchmarking exercise to determine how Honduras performs against its comparator countries. Broadly speaking, Honduras ranks poorly on international indices related to its business environment, including the World Bank Doing Business Indicators and the OECD’s “Trade Facilitation Index.” Procedures and regulations appear to be less efficient than comparator countries’, creating a challenge for Honduran firms’ ability to grow and scale their operations.

To put it simply, Honduras has a challenging business climate. In 2020, Honduras ranked 133 out of 190 countries in the World Bank Doing Business ranking, indicating a challenging environment for firms to incorporate and flourish. In the most recent World Economic Forum’s Global Competitiveness Index, Honduras was ranked second to last out of all the comparator countries in business regulations, suggesting that this is a robust finding across different methodologies.

Figure 7-12: 2020 Ease of Doing Business Ranking

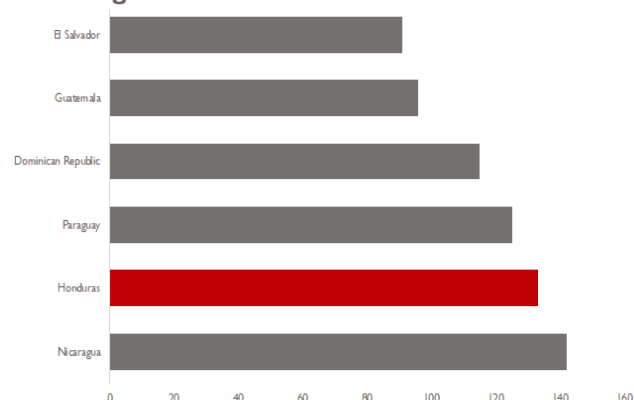
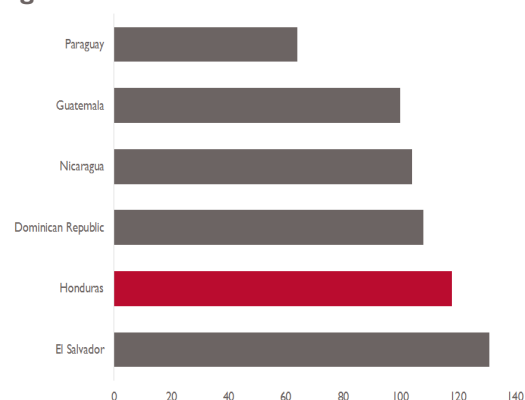


Figure 7-13: 2020 Burden of Government Regulations



Shifting attention to other aspects of the regulatory environment, it is also difficult for firms to pay taxes and obtain necessary licensing and permits. This is reflected in Honduras’ low rankings in the “starting a business” and “paying taxes” sub-indices in the World Bank Doing Business rankings. Honduras ranks last among comparators in the World Bank’s Doing Business Paying Taxes ranking. Honduran firms pay 14 different types of taxes, the most of any comparator country, and four of which are paid monthly. Starting a business requires 11 separate procedures, again the most of all comparator countries and higher than the Latin American average. In the most recent World Bank Enterprise Survey, Honduran firms identify business licensing and permits as a major constraint at significantly higher rates than firms in comparator countries.

Figure 7-14: 2020 Paying Taxes Ranking

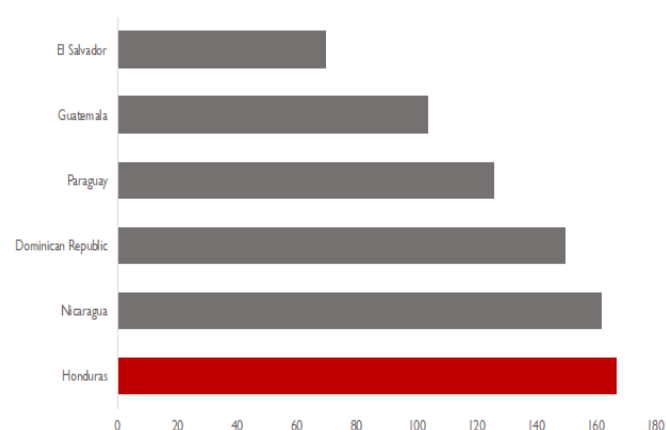
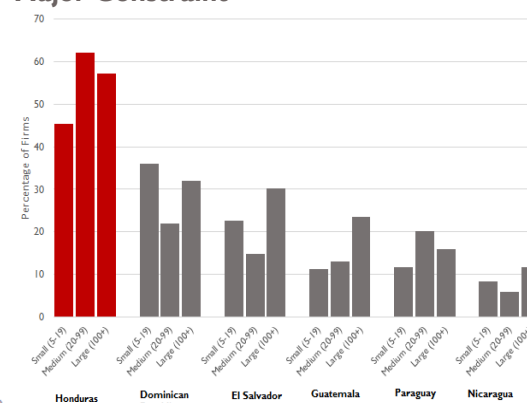


Figure 7-15: Regional Comparison of Firms that Identify Tax Administration as a Major Constraint



Customs and trade regulations also pose a major barrier to firms. Close to one-third of Honduran firms identify customs and trade regulations as a major constraint to doing business in the most recent World Bank Enterprise Surveys. Honduras also ranks last among comparators in the World

Figure 7-16: Honduran Firms Identifying Trade/Customs as a Constraint

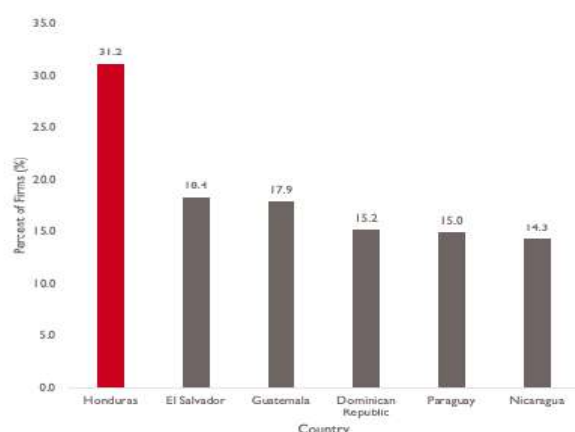


Figure 7-17: Honduras' Trading Across Border Score, 2005-2020



Bank Doing Business “Trading Across Borders” score and the OECD’s “Trade Facilitation Index.” Honduras’ “Trading Across Borders” score has steadily declined since 2007, suggesting an overall deterioration in customs and trade regulations over the last decade.

Now that Honduras’ overall position among comparator countries with respect to the regulatory environment has been established, we turn our attention to the application of the four diagnostic tests.

7.2.2 TEST I: THE SHADOW PRICE OF A BURDENSOME REGULATORY ENVIRONMENT

If the regulatory environment is a binding constraint, then the costs borne by individual firms and the broader economy as a result of this regulatory regime would be high. The comparison of key

indicators (such as customs compliance costs, the amount of time and effort required to comply with regulations and taxes, and business licensing procedures) with those of comparator countries shows that the time and monetary costs associated with a burdensome regulatory environment is high in Honduras.

Many interactions that businesses have with the government are time consuming, expensive, and complicated. As part of doing business, firms must interact with the government to receive the permits and licenses required to start a business, to pay taxes, and with the courts to enforce contracts and resolve insolvency. While not all firms need to engage the government across all of these areas, such as the need to resolve insolvency, all formal firms would need to do things like pay taxes or go through the official procedures to start a legal business

Table 7-2: Time and Monetary Costs of the Regulatory Environment in Honduras and Comparators

COUNTRY	TAX ADMINISTRATION		STARTING A BUSINESS			ENFORCING CONTRACTS		RESOLVING INSOLVENCY		
	NUMBER OF PAYMENTS	TIME (DAYS)	PROCEDURES (NUMBER)	TIME (DAYS)	COST (% INCOME)	TIME (DAYS)	COST (% OF CLAIM VALUE)	RECOVERY RATE (CENTS ON DOLLAR)	TIME (YEARS)	COST (% OF ESTATE)
Dominican Republic	7	317	7	16.5	13.7	590	40.9	9.6	3.5	38.0-
El Salvador	7	168	9	16.5	43.3	816	28.4	32.4	3.5	12.0
Guatemala	8	248	6	15	17.3	1402	26.5	28.1	3.0	14.5
Honduras	59	203	11	42	28.1	920	38.8	19.9	3.8	14.5
Nicaragua	43	201	7	14	65.7	490	26.8	35.7	2.2	14.5
Paraguay	19	379	7	35	52.2	606	30.0	23.0	3.9	9.0
Latin America & Caribbean	28.2	317.1	8.1	28.8	31.4	774.2	32.0	31.2	2.9	16.8

Table 7-2 is a summation of various time and monetary costs associated with various aspects of the business environment in Honduras and its comparator countries, from the 2020 World Bank Doing Business Report. Across a variety of measures of cost, including time and money, these interactions are often burdensome to firms. In 7 out of the 10 costs outlined in this table, Honduras performs worse than its regional comparators. In at least one measure of cost across each sub-area, Honduras performs worst or second-worst relative to comparator countries. Both facts demonstrate the ubiquitous challenges spread across the regulatory environment and support the conclusion that the administrative costs (both financial and opportunity) of doing business in Honduras is high relative to comparator countries.

These administrative burdens persist across another aspect of the regulatory environment: that of trade and customs enforcement. Table 7-3 outlines the border and documentary compliance time and costs associated with importing and exporting. According to this data from the World Bank Doing Business Report, Honduras has the highest average number of hours to export and import goods among comparator countries and the second highest average cost to export after Paraguay.

Table 7-3: Time and Monetary Costs of Trade Regulations in Honduras and Comparators

COUNTRY	EXPORTS		IMPORTS	
	TIME (HOURS)	COST (USD)	TIME (HOURS)	COST (USD)
Dominican Republic	26	503	38	619
El Salvador	33	178	49	195
Guatemala	84	415	104	442
Honduras	156	681	168	553
Nicaragua	120	287	88	486
Paraguay	144	935	60	635

Challenges with trade and customs regulations appear to be centered around issues of transparency and accountability. The OECD Trade Facilitation Index shows that Honduras performs most poorly relative to comparators on “involvement of the trade community.” As the State Department writes in its most recent report on trade in Honduras, “The Honduran government does not routinely post proposed changes to regulations. The lack of a formal notification process prevents non-governmental groups, foreign companies, and other entities from commenting on proposed changes or new regulations.” This lack of transparency, combined with frequent policy changes, contributes to an overall environment of policy uncertainty. Honduras also performs poorly on “governance and impartiality”, which refers to issues around ethics, transparency, and accountability of customs officials.

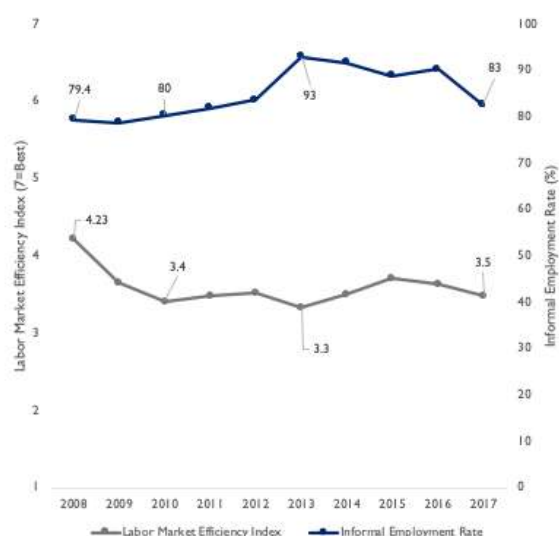
On balance, the data in the above tables demonstrate a high shadow price of the regulatory environment in Honduras relative to its comparator countries, suggesting the presence of a binding constraint.

7.2.3 TEST 2: RELATIONSHIP BETWEEN THE REGULATORY ENVIRONMENT AND AGGREGATE ECONOMIC PERFORMANCE

If a burdensome regulatory environment is a constraint, then significant changes in that environment should result in a visible change in key economic performance indicators. There have been no significant, country-level changes to the business regulatory environment in recent years, making it difficult to successfully conduct this test. However, there does appear to be a relationship between Honduras’ labor market efficiency scores and its rates of informal employment.

There is a relationship between Honduras’ labor market efficiency scores and the rates of informal employment. In the specific case of labor regulations, we see the expected impulse-response effect outlined above. Honduras’ score on the Global Competitiveness Index “Labor Market Efficiency” sub-category (which captures both labor market flexibility and matching) does appear to be somewhat related to changes in the level of informal employment, data obtained from the International Labour Organization (ILO).

Figure 7-18: Informal Employment and Labor Market Efficiency in Honduras, 2005-2017



As demonstrated in Figure 7-18, deteriorations in labor market efficiency between 2008 and 2010 were accompanied by an increase in informal employment. However, these changes to informal employment are relatively small and may have been influenced by other circumstances, including the significant rise in violence and political instability following the 2009 coup and the aftermath of the 2008 global financial crisis.

Test 2 is challenging to perform given the lack of significant changes in the regulatory regime over the period for which there is available data. However, the inverse relationship between informal employment and labor market efficiency in Honduras follows the impulse-response reaction

expected by the test.

7.2.4 TEST 3: ATTEMPTS TO BYPASS THE REGULATORY ENVIRONMENT

If the regulatory environment is a binding constraint to growth in Honduras, actors in the economy will take actions meant to bypass or mitigate its effects. In Honduras, we find evidence that economic actors are attempting to bypass the regulatory environment through a variety of avenues.

Figure 7-19: Informal Employment in Honduras

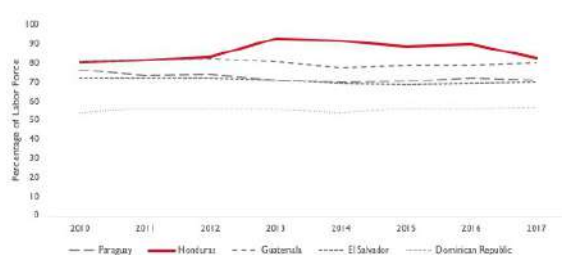
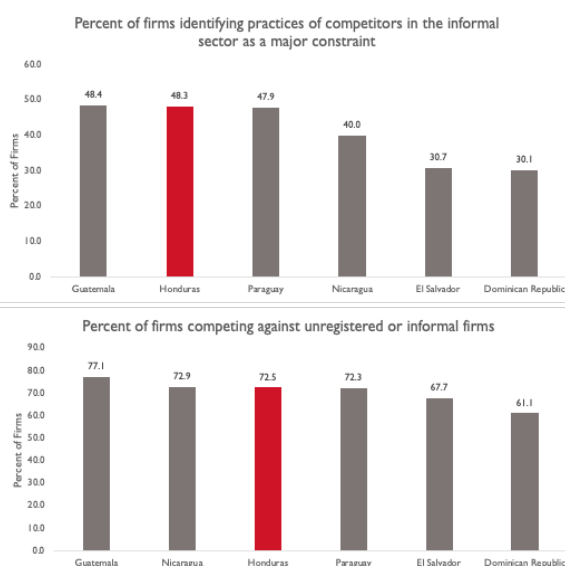


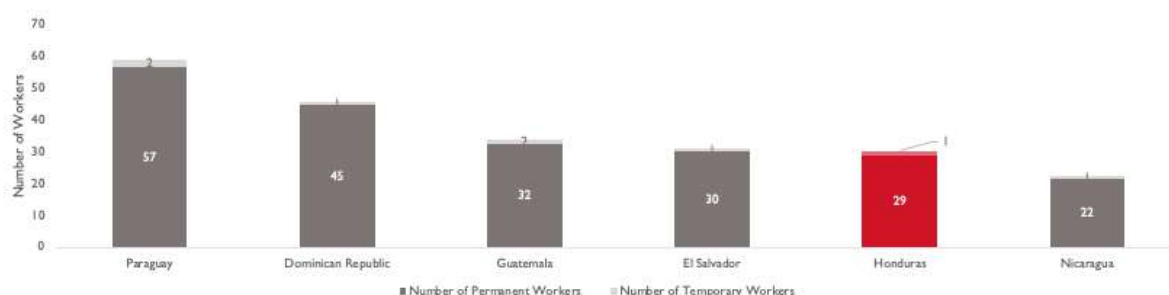
Figure 7-20: Formal Honduran Firms and the Informal Economy



A high level of informality is one potential response to firms in the economy attempting to avoid a burdensome regulatory environment. According to ILO data, Informal employment is widespread in Honduras and occurs at a greater rate than that of in any comparator country (Figure 7-19). According to data from the most recent World Bank Enterprise Survey shown in Figure 7-20, the majority (72.5 percent) of firms compete directly against unregistered or informal firms, and nearly one-half (48.3 percent) of firms identify the practices of competitors in the informal sector as a “major constraint” to doing business. Burdensome regulatory requirements likely disincentivize formalization, particularly among small firms that may lack the administrative capacity to comply with Honduras’ complex regulatory framework.

Firms in Honduras may also be bypassing constraints around labor regulations by remaining small and hiring a higher proportion of temporary workers. According to the most recent data available from the World Bank Enterprise surveys, the average firm size in Honduras is smaller than all comparators except for Nicaragua, at just 30 employees (Figure 7-21). Honduran firms also hire a higher number of temporary workers as a proportion of their total workforce than most other comparators, at 4.7%.

Figure 7-21: Average Number of Workers per Firm in Honduras



A final, more qualitative piece of evidence that suggests that the regulatory environment is a binding constraint is advertising for Honduras’ Zone for Employment and Economic Development (ZEDE), which emphasizes its strong relative regulatory environment as an incentive for investment. In other growth diagnostics (MCC Cote d’Ivoire 2015, MCC Morocco 2015, USAID Bangladesh 2014), special economic zones were utilized by firms to bypass a variety of constraints, such as challenges in infrastructure, land access, and regulatory environments.

Figure 7-22: Starting a Business in Honduras’ New Próspera ZEDE

The Comparison	Honduras	United States	Próspera ZEDE
Number of Compliance Steps	11	6	3
Compliance Time (Days)	42	4	1
Total Compliance Costs (USD)	\$955.78+* (No insurance included) *This does not include the \$2,000+ required to have an attorney file entity registration.	\$775 (No insurance included)	\$540-1840 (Including liability insurance; cost reduced to \$540 for each subsequently created entity by the same resident)

Figure 7-22 shows a screenshot from the ZEDE’s website that is used to advertise this new type of special economic zone.³⁶ Similar graphics occur on the website that address obtaining permits, complying with regulations, complying with labor law, paying taxes, and resolving disputes. On this

³⁶ <https://prospera.hn/business/>

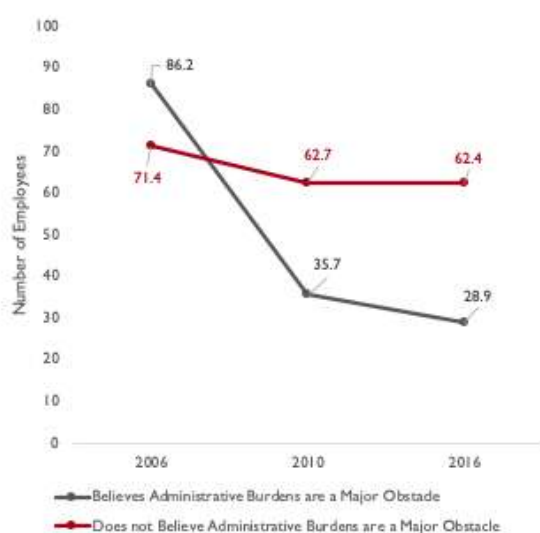
website, *only* the strong regulatory environment has been highlighted as a selling point for the ZEDE, suggesting that this is the primary appeal for its use by private businesses.

There is strong evidence that economic actors in Honduras bypass the regulatory environment. Relative to comparator countries, more Honduran firms opt to remain in the informal sector, maintain few full-time employees, and utilize temporary workers. The Honduran government is also advertising its new Zone for Employment and Economic Development on the basis of its favorable regulatory environment.

7.2.5 TEST 4: DIFFERENTIAL FIRM PERFORMANCE IN HONDURAS' REGULATORY ENVIRONMENT

If a burdensome regulatory framework is a constraint, then firms that are relatively less impacted by its high administrative costs are more likely to stay in business and grow compared to those whose businesses are particularly impacted by a poor regulatory environment. In Honduras, there is some evidence to suggest that this is the case in certain instances. Firms less hampered by the regulatory environment appear to have better long-term growth prospects than firms that are more impacted by the constraint.

Figure 7-23: Average Number of Employees by Perception of Administrative Burden, 2006-2016



Firms who believe that administrative and regulatory burdens are a major obstacle employ fewer workers. Using data from the most recent World Bank Enterprise Surveys, we found that firms who believe that administrative and regulatory burdens (including trade and customs regulations, tax administration, labor regulations, and licensing and permits) are a “major” or “severe” obstacle employ significantly fewer individuals than firms who do not believe that these burdens are an obstacle (p-value = 0.075). The average number of employees at firms that believe regulatory burdens are a serious obstacle has shrunk over time, suggesting that challenges around regulatory and administrative burdens may hamper firm performance (in terms of job creation) over the

long-term. However, there is no statistically significant difference in sales performance between these two groups of firms.

In fulfillment of Test 4, firms who believe that administrative and regulatory burdens are an obstacle employ significantly fewer workers than those that do not, suggesting that challenges around regulatory and administrative burdens may hamper firm performance (in terms of job creation) over the long-term, though no negative effect is evident on firm sales.

7.2.6 THE REGULATORY ENVIRONMENT AND INCLUSIVITY

The regulatory environment in Honduras affects firms of different sizes in different ways (Figures 7-24 and 7-25). SMEs find the practices of the informal sector to be a significant obstacle and find tax administration issues less of a challenge. For large firms in Honduras, tax administration is one of their greatest obstacles, with informality a more minor concern. Formal Honduran SMEs that must comply with government regulations and bear the significant time and monetary costs are competing

with a large informal sector using their informality to their competitive advantage by circumventing these same regulations. Large Honduran firms are less likely to compete with informal firms, making their practices less of a concern, but remain saddled with administrative burdens directly.

Figure 7-24: Informality as an Obstacle

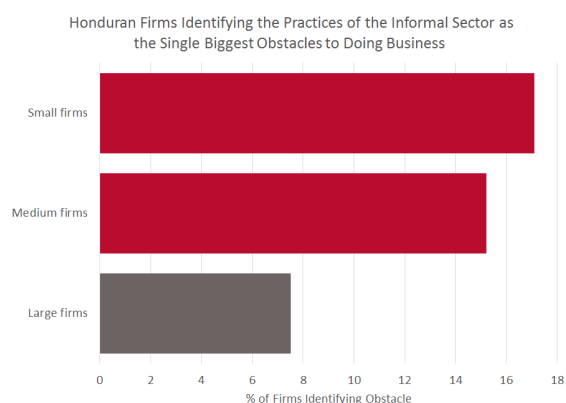
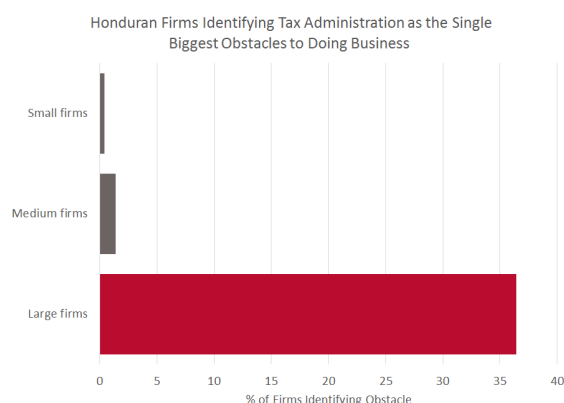


Figure 7-25: Tax Admin. as an Obstacle



7.3 NON-BINDING MICROECONOMIC RISKS

In addition to the microeconomic risks that were identified as binding constraints above, we also examined several other microeconomic risks that were not seen as binding, including tax rates and access to land.

7.3.1 TAX RATES

While tax administration is a challenge, tax rates are in line with comparator countries, based on data from the 2020 World Bank Doing Business Report (Table 7-4). While Honduras has the highest rate of profit tax out of comparators, it is in the middle of comparators in total tax and contribution rates, suggesting that rates are in line with the region and their shadow price is not relatively high.

Table 7-4: Tax Rates by Type in Honduras and Comparator Countries

COUNTRY	TAXES BY TYPE (RATES AT % OF PROFIT)			
	PROFIT TAX	LABOR TAX AND CONTRIBUTIONS	OTHER TAXES	TOTAL TAX AND CONTRIBUTION RATE
Dominican Republic	29.1	18.6	1.1	48.8
El Salvador	16.6	18.3	1.4	36.3
Guatemala	20.2	14.3	0.7	35.2
Honduras	29.2	8.8	1.1	39.1
Nicaragua	17.3	23.7	19.6	60.6
Paraguay	9.6	18.6	6.7	34.9

In the most recent World Bank Enterprise Survey, SMEs in Honduras cite tax rates as their biggest obstacle at a higher rate than large firms. This relative difference between SMEs and large firms is the inverse for citing practices of informal firms as an obstacle, suggesting that these two constraints are likely linked.

7.3.2 ACCESS TO LAND

Access to land and challenges regarding land tenure are not a binding constraint to growth. Honduras is in line or better than most comparator countries with regard to property rights protections, the cost of registering property is low, and firms do not consider land access to be a major obstacle to doing business.

Figure 7-26: Registering Property in Honduras and Comparators

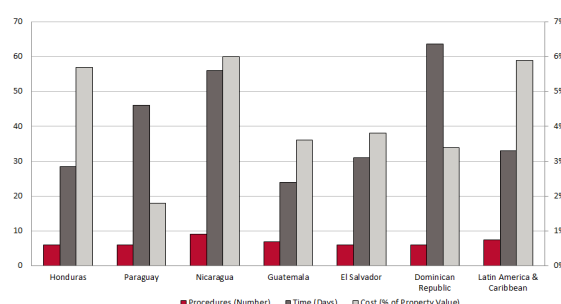
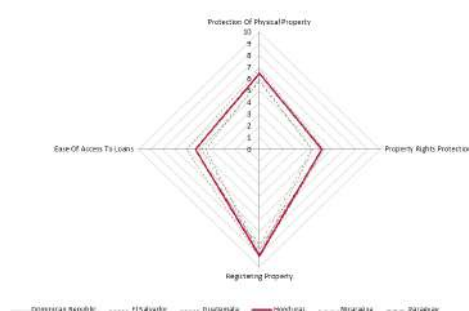
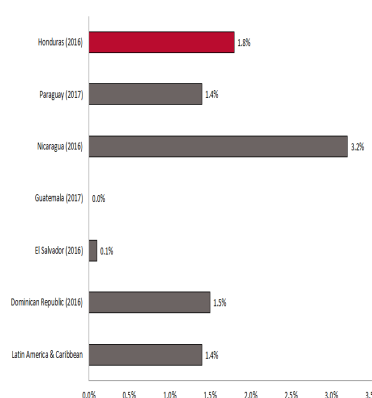


Figure 7-27: Property Rights in Honduras



Honduras performs adequately on a variety of land access and property rights-related measures. The complexity and cost (in time and money) of registering property in Honduras is in line with comparator and regional averages (Figure 7-26). Property rights and their related protections in Honduras appear to be in line with those in comparator countries, according to the International Property Rights Index (Figure 7-27). The Heritage Foundation also found that of comparator countries, only the Dominican Republic has stronger property rights than Honduras.

Figure 7-28: Firms Identifying Access to Land as their Greatest Obstacle



In addition to Honduras' performance on the relevant international indices, land access is not identified as a significant obstacle by firms themselves. Though Honduran firms do consider land access to be a challenge at a slightly higher rate than comparator countries, only 1.8 percent of firms surveyed consider it to be their single biggest obstacle to doing business, the 14th out of 15 obstacles included in the World Bank Enterprise Survey.

Finally, Honduras' Zone for Employment and Economic Development does not use land access in its advertising. In other growth diagnostics, one example of firms circumventing business enabling environment constraints, including access to land, is a

high use of special economic zones, areas where laws regarding the business environment and trade are different and often more business-friendly relative to the rest of the country. The website for Honduras' Zone for Employment and Economic Development (ZEDE) highlights its business enabling environment and tax and labor laws that appeal to firms but contains no mention of land access as a positive feature of the ZEDE, suggesting that that firms are unlikely to use ZEDE to bypass a land access constraint.

8 MARKET FAILURES

In a modern, well-functioning economy, innovation can be a key driver of economic growth. As new ideas, processes, products, and types of businesses are paired with financial resources, new dynamic sectors emerge, creating wealth and jobs. In some contexts, however, the efficient matching of ideas and funding can be impeded by a number of different obstacles that private sector actors are unable to overcome independently. For example, in the presence of information externalities (i.e., when the value of information to an economy exceeds the value to individual firms) or coordination failures (i.e., when the value from a set of investments to an economy exceeds the sum of the gains earned by individual firms acting alone), private sector actors may opt not to pursue new opportunities that would generate economic expansion precisely because the economy would not fully compensate their efforts (“lack of appropriability”), even if adequate returns would be generated economy-wide. While various types and intensities of market failures are present in every economy, and academic literature documenting imperfect markets dates back nearly a century (Robinson 1933), they rarely are so problematic that they rise to the level of being the primary barrier to broad-based economic growth.

Honduras is no outlier in this regard, as the analysis in this report indicates that market failures are not a binding constraint on private sector growth and investment in the country. Although the Honduran economy exhibits some negative signals that could indicate the presence of a market failure-related constraint, this evidence does not rise to the level of the evidence presented for the binding constraints highlighted earlier in this study. Further, there is reason to believe that the negative evidence presented here is more likely a symptom of constraints elsewhere in the economy which disincentivize research and development (R&D) and innovation, namely the education challenges described in the human capital chapter (holding back the development of a cadre of research and development professionals) and the challenging regulatory environment (increasing the costs for entrepreneurs to pursue novel business ventures).

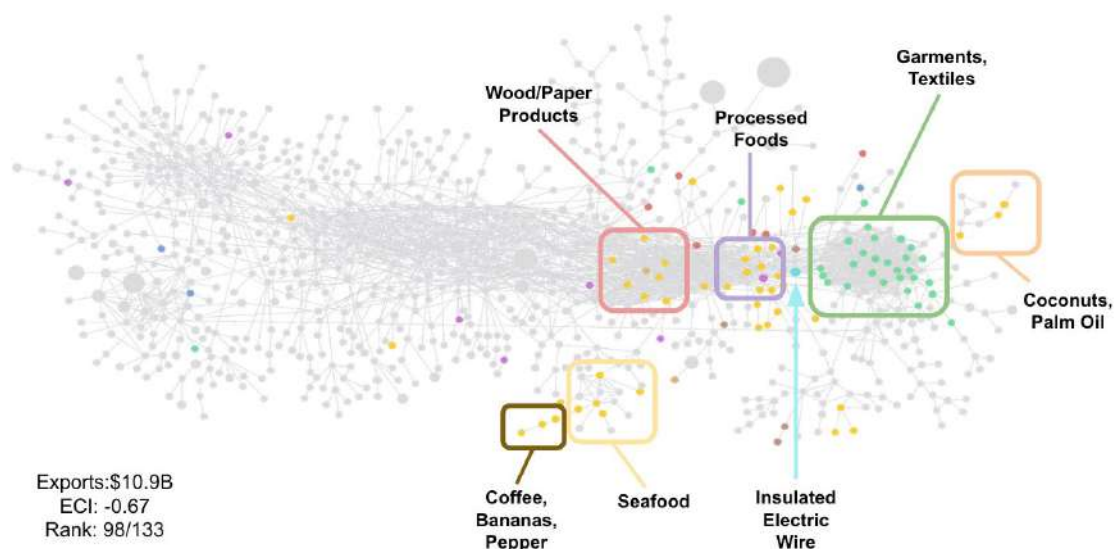
In the context of the broader report, benchmarking and IGD tests in this chapter generally support non-bindingness, although performance is relatively poor. Benchmarking indicates that export complexity for goods has improved very little over the past two decades, international rankings on research and development are low, and there are relatively few R&D professionals. Levels of high-tech exports are low, consistent with the hypothesis that low innovation is holding back growth in Honduras (Test 4). Conversely, the formation of the call center / business process outsourcing industry demonstrates that the country can successfully move into new industries (Test 4). While high wages for R&D professionals could indicate a constraint, they more likely substantiate issues with human capital rather than market failures per se (Test 1).

8.1 THE STRUCTURE AND SOPHISTICATION OF HONDURAN EXPORTS

As noted in the economic growth overview, Honduras’s goods export basket is mainly composed of garments and textiles and agricultural products like coffee, bananas, palm oil, and crustaceans. This structure has changed extraordinarily little over the past two decades, a troubling sign for future economic growth. In the “product space” of exports (Figure 8-1), the most complex, interconnected products (e.g., motor vehicles) are located in the central core. With products that Honduras does export highlighted in color, it is easy to see that Honduras produces and exports very few of the complex products found in the core of the product space. Instead, we see a large cluster of garment/textile exports on the right-hand side, some processed wood/paper and food products in the core, and largely unprocessed agricultural products along the periphery. While some

descriptions of the Honduran export sector note the growing importance of electronics, this largely refers to insulated electrical wire, a relatively basic product for that sector.

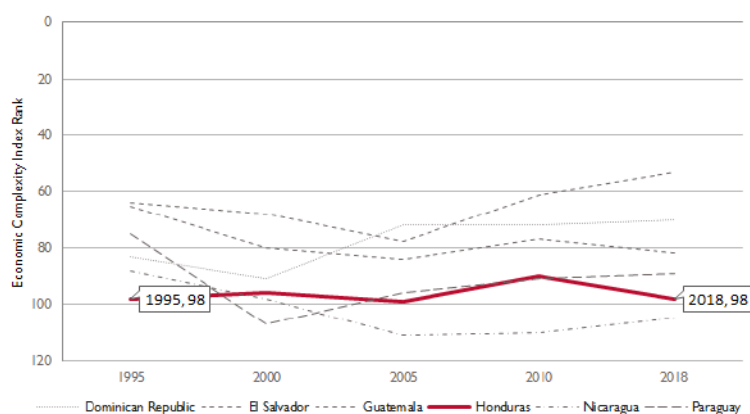
Figure 8-1: Product Space of Honduras' Goods Exports



Source: Harvard University, *Atlas of Economic Complexity* (2018)

As demonstrated by Figure 8-2, Honduras's export complexity has been stagnant for over two decades. Honduras's economic complexity index has been at the lower end among comparators for decades, and as of 2018 was the second lowest among comparators, surpassing only Nicaragua. While the economic complexity index of Honduras has edged up slightly over this time, from -0.74 in 2000 to -0.67 in 2018, its global rank has dropped from 96/132 to 98/133 over the same period, as other countries have made faster advances. Even simply by looking at versions of Figure 1 from 2000 and 2018, it is difficult to discern any meaningful difference; however, the same is not true of the Dominican Republic, where clear movement out of the garment/textile cluster and into more complex, higher value-added products can be seen over the past 20 years.

Figure 8-2: Economic Complexity Index Ranking, 1995-2018

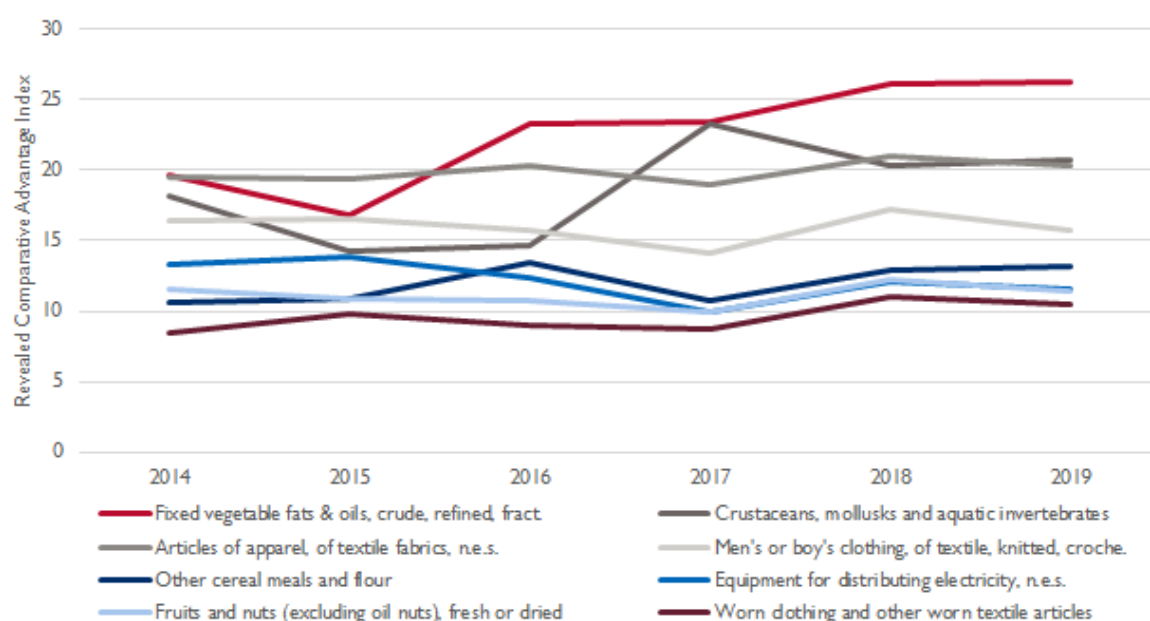


Source: Harvard University, *Atlas of Economic Complexity* (2018)

It does not appear that there are strong prospects for the rapid development of new, higher valued-added goods export products and clusters in the coming years (Figure 8-3) that would bolster Honduras' future economic prospects. Those products with the greatest revealed comparative advantage (i.e., goods that Honduras exports relatively more intensely than the world as a whole)

include coffee, refined vegetable fats and oils, crustaceans, apparel, cereal meals/flour, electrical wire, fruits and nuts, and used clothing. All are relatively simple products, and other than electrical wire, each sit within export clusters (agricultural products and garments/textiles) where Honduras is already relatively active.

Figure 8-3: Products with Greatest Revealed Comparative Advantage, 2014-2019



Source: United Nations Conference on Trade and Development

Note: Coffee, with a revealed comparative advantage of 74, was excluded from this chart.

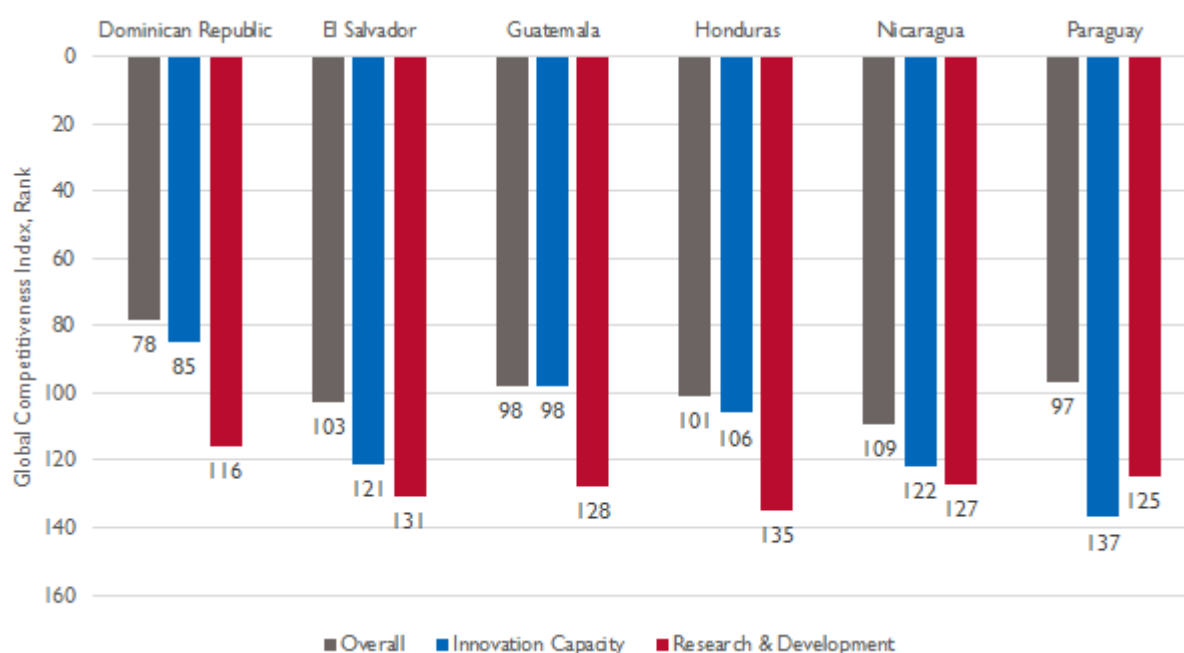
It must be noted that this data is limited to goods exports, which are not the most dynamic aspect of the Honduran export sector. Instead, services exports have grown consistently in recent years, including in some relatively higher value sectors, with major growth in information and communication technology (ICT) services (e.g., call centers and business process outsourcing) and travel and tourism accounting for 17 percent and 8 percent of total goods and services exports, respectively (Harvard, Atlas of Economic Complexity). As such, the narrative of stagnant goods export complexity described in this section does not tell the entire story of the Honduran export sector.

8.2 THE ENABLING ENVIRONMENT OF INNOVATION IN HONDURAS

Honduras ranks 135th in the world for research and development,³⁷ per the most recent Global Competitiveness Index published by the World Economic Forum (Figure 8-4). This is worse than its overall ranking (101st) and innovation pillar ranking (106th), implying that it is generally a lagging area of competitiveness for the country. In fact, no sub-pillars ranked worse for Honduras in the 2019 edition of the index. That being said, similar to the crime and security chapter, all other comparators ranked relatively poorly on the R&D sub-pillar, with the best performer, the Dominican Republic, ranking just 116th, suggesting that Honduras is in-line with comparators in this area.

³⁷ The R&D sub-pillar is based on scientific publications, patent applications, R&D expenditures, and the prominence of research institutions.

Figure 8-4: World Economic Forum Innovation Capacity and R&D Rankings



Source: World Economic Forum, *Global Competitiveness Report* (2019).

While this overall index paints an initial picture, more targeted data on R&D expenditures and professionals confirms the low levels of R&D present in Honduras. As of 2016, just 7.4 percent of firms spent money on R&D, the second-lowest percentage among comparators. Further, the number of R&D professionals—both researchers and technicians—is low relative to those comparator countries that provide data, with 35 researchers and 10 technicians per million people.

Figure 8-5: Firms that spend on R&D

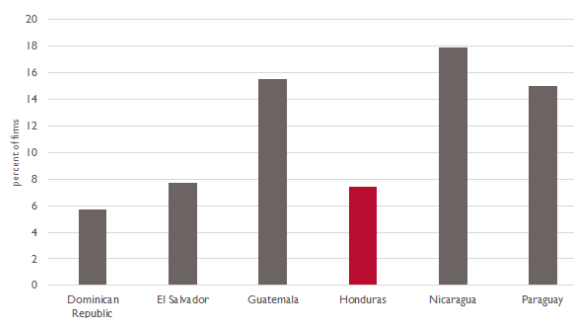
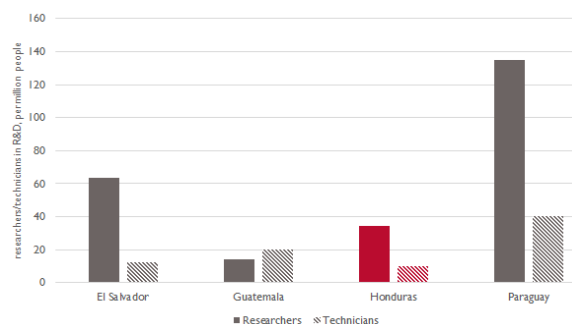


Figure 8-6: R&D Researchers & Technicians



Source: World Bank, *World Development Indicators*

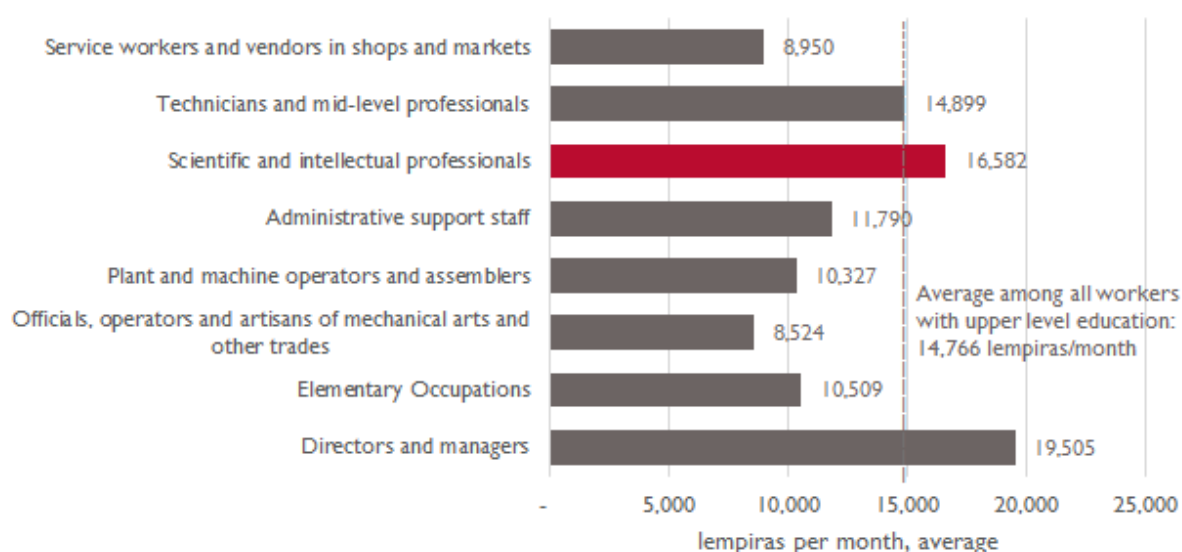
8.3 DIAGNOSTIC TESTS

Three diagnostic tests were performed to determine whether market failures present a binding constraint for private sector-led investment and growth in Honduras. While two of these tests may present some evidence of a market failures-related constraint, they should be read within the broader context of the chapter and report.

8.3.1 TEST 1: IS THE SHADOW PRICE OF THE CONSTRAINT HIGH?

First, to test whether the shadow price of the constraint is high, the wage (in this case, the shadow price) paid to potential R&D workers is compared against the average wage for other Honduran workers with a similar upper education level. Since the wage for scientific and intellectual professionals is significantly higher than the average wage (Figure 8-7), the most straightforward interpretation is that the shadow price for R&D is high, indicative of the presence of a constraint. However, it is more likely that this is simply an additional indication of the broader human capital constraint, particularly considering the overall high returns to education in Honduras and the specialized skills required to work in R&D. Further, the low supply of potential R&D workers (Figure 8-6) is perhaps more likely to be the primary reason for the high wage, as opposed to outsize demand for such workers.

Figure 8-7: Average monthly income for Hondurans with upper-level education, by occupation



Source: National Survey of Household Income and Expenditure, 2019.

Note: Of 24,094 respondents, this chart only considers those with “superior” education level (1,826) currently receiving income from their primary activity (1,024). The chart only shows categories with 15+ responses.

8.3.2 TEST 4: DO FIRMS THAT ARE MORE HINDERED BY THE CONSTRAINT PERFORM WORSE THAN FIRMS THAT ARE LESS HINDERED BY THE CONSTRAINT?

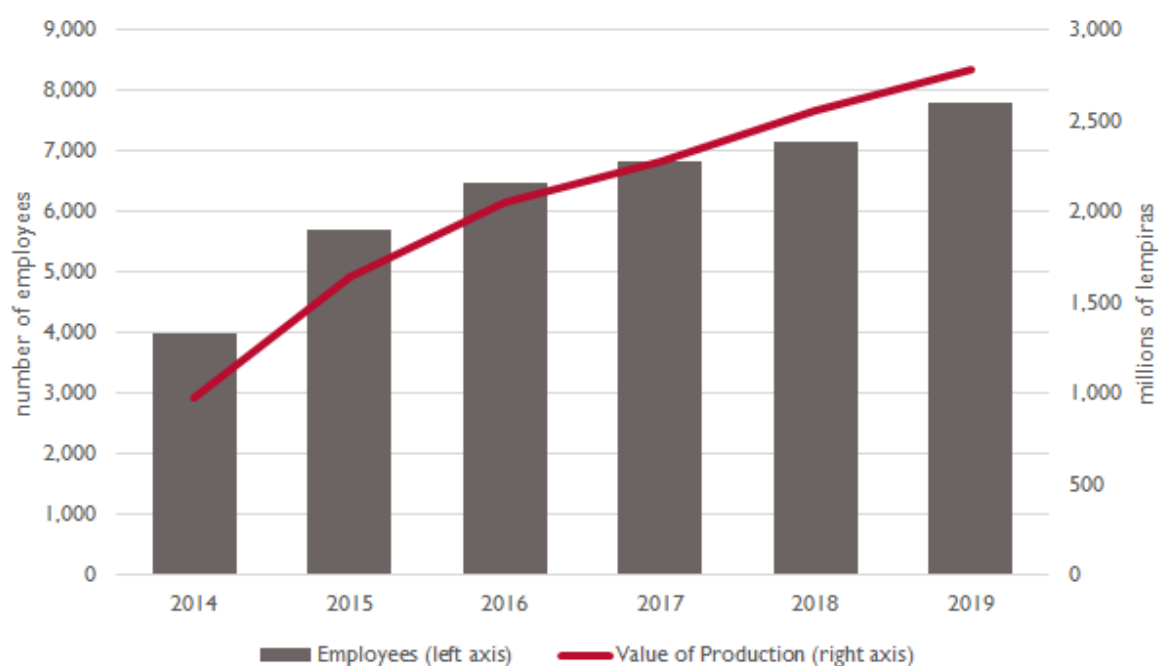
Two different versions of Test 4 were run to determine whether firms that are less intensive in the constraint do better than firms that are more intensive than the constraint. If market failures are constraining economic growth in Honduras, we would expect to see evidence that firms that are less dependent on innovation perform better than firms that are more innovation intensive. While the first test indicates that there could be a constraint present, the second both refutes this hypothesis and provides further evidence for the administrative costs constraint.

In the first version of this test, we employ the same camels and hippos test applied in the human capital chapter and examine high tech exports. As noted in that chapter, Honduras exports fewer high-tech goods as a percentage of manufactured exports than all comparator countries, except for Nicaragua. While this is the expected result in a country where market failures present a binding constraint, this piece of evidence alone is not sufficient to determine the presence of severe growth-

constraining market failures, particularly in the context of the second version of this test discussed below.

In the second version of this test, we look at the growth of call centers and business process outsourcing in Honduras. Despite the stagnancy in the variety and complexity of goods exports (typified by the low level of high-tech exports discussed above), Honduras has seen rapid growth in call centers servicing international markets. With the first call center established in 2010, the industry has grown to 10 firms with nearly 8,000 employees and production nearing 3 billion lempiras (Figure 8-8), both growing faster than the average rate for businesses producing goods under the free zone regime.³⁸ This rapid growth of an entirely new export-oriented industry belies the notion that Honduras suffers from endemic market failures.

Figure 8-8: Call Center Employees and Production



Source: Banco Central de Honduras, *Bienes para Transformación y Actividades Conexas* (2014-2019).

Given that these call centers are largely located in free zones with a more business-friendly regulatory regime³⁹ (e.g., Altia Business Park in San Pedro Sula),⁴⁰ it provides further evidence that reduced administrative costs can allow new business sectors to flourish. Notably, the growing call center industry contrasts with the stagnant goods export sector, supporting the conclusion that administrative trade costs and delays pose a constraint for private sector growth and investment in Honduras.

³⁸ Banco Central de Honduras, *Bienes para Transformación y Actividades Conexas* (2014-2019).

³⁹ Tim Wilson, Nearshore Americas, *The Case for a Sustainable BPO Ecosystem in Honduras* (December 2, 2019). <https://nearshoreamericas.com/the-case-for-a-sustainable-bpo-ecosystem-in-honduras/>

⁴⁰ Asociacion Hondureña de Maquiladores, *Call Centers*. http://www.ahm-honduras.com/?page_id=965

9 CONCLUSION AND RECOMMENDATIONS

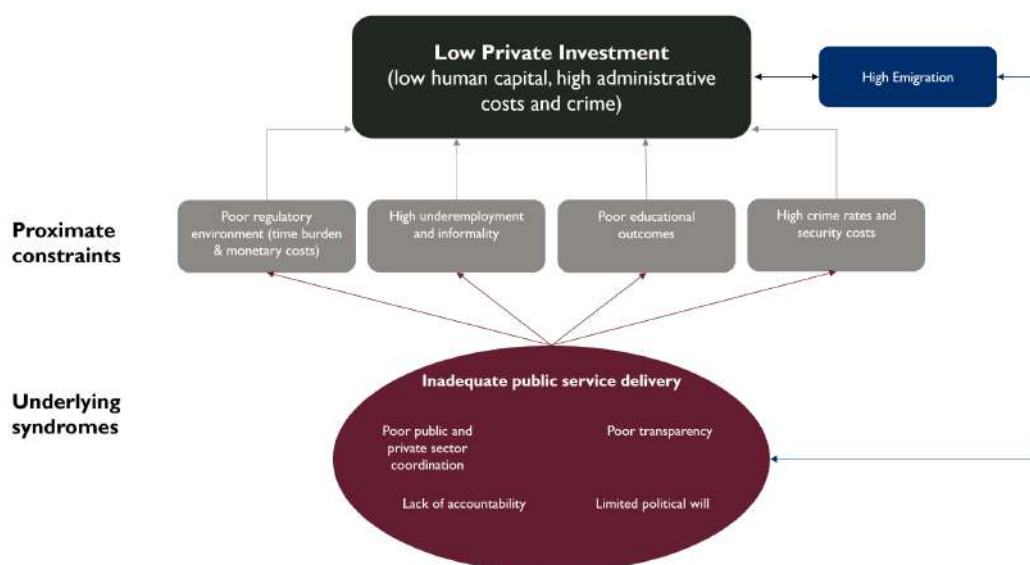
In the past 20 years, Honduras has had decent growth driven primarily by private household consumption and remittances. Furthermore, the country's economy has been resilient in response to COVID-19 as remittances and exports have rebounded and firms and workers are returning to economic activities. Nonetheless, there have been varying levels of private investment, the rate of growth declined prior to the pandemic, and Honduras has extremely high levels of poverty and inequality. This lack of economic opportunity is the main reason given for immigration.

Using the HRV growth diagnostic methodology, findings from this study indicate that private investment and inclusive growth are being limited by low economic returns to investment. Specifically, there is strong evidence suggesting the binding constraints to inclusive growth are (1) human capital (inadequate education), (2) high administrative costs, and (3) crime and security. The final step of the analysis is to derive a logical causal story or “syndrome” to explain why these constraints exist and to propose potential solutions for addressing it.

9.1 SYNDROME FOR THE CONSTRAINTS

To identify recommendations for addressing these greatly constrained factors, we first need to uncover the syndrome of these constraints, which should be evident across each topic. We also need to acknowledge the uncertainty associated with any proposed syndrome, as there is no diagnosis or experimentation to prove its existence. In response to this uncertainty, Hausmann et. al state there “is a tradeoff for the analyst between getting the perfect diagnosis with all the experiments in a wish list and getting a diagnosis that can add value to decision making” (2008). The underlying message is that decision makers will make policy decisions in the absence of evidence, so it is better to make an informed decision while acknowledging any potential uncertainties.

Figure 9-1: Honduras IGD Hypothesized Growth Syndrome



Source: IGD authors adaptation of Harvard Center for International Development syndrome diagram (2018).

The syndrome for the constraints is informed by two workshops that were held in March 2021 and April 2021 with the private sector, academia, numerous subject matter experts, and USG personnel, among others. Participants were presented with evidence from the IGD and asked specific questions about the underlying cause for each of the binding constraints. A consistent theme among the responses was that limited public service delivery was causing many of these issues (Figure 9-1). The symptoms used to derive this syndrome were a lack of transparency and accountability, limited political will, and poor public and private sector coordination. In the following section, a description of the syndrome and its symptoms is provided for each constraint.

In the case of human capital, this syndrome is expressed in several ways. Poor coordination between the public and private sector has resulted in a technical and vocational training system which fails to meet the needs of the private sector. Limited political will and accountability have manifested in repeatedly frustrated efforts by civil society groups to reform Honduras' education system, including constructing more schools in rural areas and strengthening efforts to retain students at the secondary level. These poor educational outcomes, combined with a complex regulatory environment, contribute towards rampant underemployment and informality in the labor market, increasing the economic insecurity that keeps many children out of school.

This syndrome also expresses itself via the poor regulatory environment. Administrative processes are redundant and lack systemization, and there is limited transparency around the regulatory process. Public officials often benefit from the opportunities and contradictions created by this environment, resulting in a lack of political will to tackle simplification and reform efforts, which in turn gives rise to the continued redundancy of administrative processes in an overly complicated legal framework. The lack of accountability of the state to follow through on commitments for reform further entrenches this constraint.

Limited public service delivery also manifests itself in the crime and security constraint. Lack of accountability and political will results in impunity and a weak judicial system. The police and judicial system is not effective at investigating and enforcing laws and prosecuting criminal activity. For crimes that are reported, investigated, and solved, the perpetrators often face limited consequences and go on to continue their criminal activities. There is also a lack of collaboration between the public and private sector on issues of crime and security, often due to the perceived linkages of government actors themselves to these problems.

All these factors contribute to an environment in which opportunities for economic advancement are limited, thereby increasing individuals' incentives to migrate. This migration, in turn, spurs a vicious cycle: high remittance receipts increase the reservation wage, lowering competitiveness and labor force participation and disincentivizing public service delivery reforms. Thus, public service delivery continues to be poor, locking the economy in a low-level equilibrium.

9.2 RECOMMENDATIONS

Although the following recommendations reflect the feedback given at each workshop, it is important to acknowledge that finding solutions to a syndrome as complex as inadequate public service delivery would require separate research and consultations. With this limitation in mind, below you will find the potential recommendations for addressing the syndrome.

Any policy or programmatic decisions would be further informed by a political economy analysis to identify feasible solutions for addressing the underlying syndrome. Our analysis does not attempt to incorporate political economy considerations. That is, it identifies

key constraints to growth, the underlying syndrome, and provides potential recommendations without assessing the political or practical feasibility of reform efforts targeting these constraints.

Public and private sector actors should improve engagement, coordination, and policy development. There is a critical need for increased engagement between the Government of Honduras, the private sector and academia in designing policy and strategy. The valuable input of both public and private sectors will go hand-in-hand to develop solutions that address Honduras's constraints and pave the way for structural economic progress and growth.

The GOH and other actors should embrace digitization and improved utilization of e-platforms to reduce inconsistencies, streamlines services and increase transparency. One innovative solution that was proposed for addressing crime and security was encouraging the adoption of digital payments, which would decrease the exposure of service enterprises to extortion and theft due to the reduced handling of cash.

Honduras needs a new education policy and vocational training law. This should include a refreshed academic curriculum to address the wide gap in supply and demand for skills and provide quality educational services to children in harder to reach areas. The reforms should also create a certification system for distance learning platforms to improve and standardize educational quality.

Honduras should increase transparency for government processes and transactions. This transparency, combined with broader adoption of anonymous reporting mechanisms (along the lines of the reporting mechanism for La Fuerza Nacional Anti Maras y Pandillas), could provide a means to improve public service delivery and citizen responsiveness. This is particularly salient to the judicial system, especially as it relates to reducing impunity and improving judicial system outcomes.

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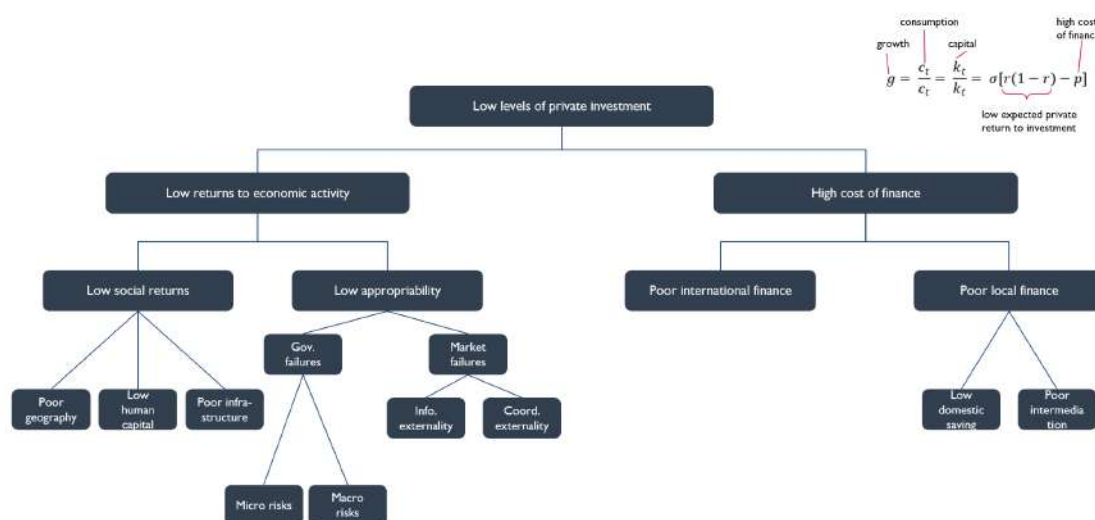
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APPENDIX A GROWTH DIAGNOSTIC METHODOLOGY

The purpose of the Honduras IGD is to identify the constraints that deter households and firms from making investments and taking risks that would significantly increase their incomes. The IGD is not intended to dictate specific projects to be funded, but rather to provide a framework that will focus attention on appropriate programs that will ease those constraints and stimulate growth. The methodology is based on the premise that growth leads to poverty reduction and growth is driven by private investment and entrepreneurship. The degree of investment and entrepreneurship depends on the economic return on investments, the cost of financing these investments, and the associated risk.

Successfully undertaking an IGD involves posing and answering a sequence of diagnostic questions that highlight the constraints to investment. Figure A-I below presents a hierarchy to organize and motivate the questions driving the IGD based on the organizing framework presented by Hausmann, Rodrik, and Velasco (2005). Answering those questions involves (1) selecting and formulating the diagnostic questions for Honduras, (2) researching and marshaling key evidence and data that shed light on these questions, and (3) answering the questions given the balance of such evidence.

Figure A-I: Inclusive Growth Diagnostic Decision Tree Framework



To help make the diagnostic framework of Figure A.I operational, Hausmann, Klinger, and Wagner (2008) offer four “principles of differential diagnosis” that are helpful in identifying constraints to growth, set forth in Table A.I.

No single principle or test is sufficient to declare a given constraint to be the most binding for economic growth. Instead, the methodology requires conducting multiple tests across each ‘node’ of the framework and aggregating these tests to make the most credible conclusion. Furthermore, we employ two additional considerations across each of the decision tree nodes. First, we perform a benchmarking exercise to show how Honduras is performing relative to a set of comparator countries. Second, we consider matters of inclusivity across each one of these decision tree nodes.

Table A-1: Four Principles of Differential Diagnosis

Principle	Explanation	Example
<i>The shadow price of the constraint should be high.</i>	The shadow price indicates whether the opportunity cost or value to a consumer is greater than the market price.	Human capital may be a constraint if there are high returns for an additional year of schooling.
<i>Movements in the constraint should produce significant movements in the objective function.</i>	When the constraint is relaxed, there is a positive market reaction (investment and entrepreneurship increase).	Reducing tax rates results in an increase in investment when tax rates are a constraint.
<i>Agents in the economy should be attempting to overcome or bypass the constraint.</i>	Economic actors should be taking observable steps to circumvent the constraint.	Firms purchase generators instead of relying only on the grid when electricity is a constraint.
<i>Agents less intensive in the constraint should be more likely to thrive, and vice versa.</i>	Firms should flourish if they are better suited to the domestic business environment. Referred to as the “camels and hippos” test.	Human capital may be a constraint if “surviving” firms use production technologies with low human capital inputs

A key feature of growth diagnostics is benchmarking the country under investigation against a list of comparator countries. These comparator countries should remain consistent across the various stages of the analysis and play a central role in applying the principles of differential diagnosis in line with the methodology. Comparator countries or “comparators” are used to control for common fixed characteristics (e.g., geography, demography) among country peers, as well as to benchmark progress on various socioeconomic indicators.⁴¹ A regional average is also typically used to provide context and help anchor where Honduras and the other comparators are relative to the broader region.

For the Honduras growth diagnostic, two methods were used to generate a set of potential comparators. First, a literature review of recent growth diagnostic-like studies and resources on Honduras was undertaken. These include MCC’s 2013 constraints analysis,⁴² a World Bank comparator selection tool,⁴³ and three recent World Bank Group reports.⁴⁴ If a country was included in at least one of these studies, it is included in the list of potential comparators. Except for the World Bank comparator selection tool, all comparator countries used in recent studies were geographically located in Latin America and the Caribbean.

⁴¹ Key outcome variables typically used to reach final conclusions as part of the analysis, such as the lending interest rate, returns to education, remittance flows, or the cost of electricity, for example, must never be used as control variables. This could lead to endogeneity issues, undermining the purpose of the analysis.

⁴² <http://www.investhonduras.hn/docs/proys/MCC/Honduras%20Constraints%20Analysis.pdf>

⁴³ <https://mec.worldbank.org/comparator>

⁴⁴ [Doing Business \(2020\)](#), [Honduras Systematic Country Diagnostic \(2017\)](#), [Honduras Jobs Diagnostic \(2020\)](#)

The second method was a k-means cluster analysis, where several different combinations of fixed characteristics⁴⁵ were used to “cluster” countries most alike to Honduras. Since this analysis is region-agnostic, several potential extra-regional comparators arose, notably the Kyrgyz Republic, Cambodia, Jordan, and Laos. However, given the precedent of other studies focusing on regional comparators, only regional peers that appeared in at least one cluster with Honduras were included in the list of potential comparators.

Once the full list of potential comparators was generated, they were categorized into definite, possible, or unlikely comparators through a closer review of the data. After a research team consultation, the following comparators were selected for this study (Figure A-2): El Salvador, Guatemala, Nicaragua, the Dominican Republic, Paraguay, and LAC (excluding high income).⁴⁶

Figure A-2: Honduras Comparator Countries



While the IGD methodology can lead to significant and valuable insights that inform better decision-making, we want to make its limitations clear. Most importantly, this methodological approach will not prescribe specific interventions in response to our diagnosis of the most binding constraints to growth. In the same way that diagnosis and treatment of a disease are separate medical functions, we leave the ultimate ‘treatment’ of the binding constraints to others.

This limitation has three important implications. First, our analysis does not account formally for current reforms or initiatives that may impact economic growth. This stems from our reliance on

⁴⁵ Criteria included (log) population, population density (people per sq. km), age dependency ratio (dependents as % of working-age population), (log) GDP per capita, exports (% GDP), natural resource rents (% GDP), surface area (sq. km), and arable land (% land area)

⁴⁶ World Bank list: Argentina, Belize, Bolivia, Brazil, Colombia, Costa Rica, Cuba, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Paraguay, Peru, St. Lucia, St. Vincent and the Grenadines, Suriname, Venezuela.

data, which has not yet been collected on events still in motion. Second, our analysis does not attempt to incorporate political economy considerations. That is, it identifies key constraints to growth in Honduras without assessing the political or practical feasibility of reform efforts targeting these constraints. Third, our analysis does not account for the cost-effectiveness of interventions. Beyond the potential political constraints to intervention, there may also be financial or economic constraints that limit the feasibility of action.

Further research, such as a political economy analysis of reform options for Honduras, or cost-benefit analysis at the project level, would provide a more comprehensive understanding of the types of interventions that would be both feasible and impactful. With that said, we are reporting the recommendations for addressing these constraints and the underlying syndrome that were provided by stakeholders during the two workshops that are associated with this analysis. We have done this at the request of stakeholders so they would have a better understanding of the potential steps needed to address these issues. However, we do not believe this approach addresses many of the limitations mentioned above.