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REVENUE MOBILIZATION[1]

This note looks at revenue mobilization efforts in Honduras. The country has made considerable progress over the last years, helping to stabilize its fiscal position. Compared to peers, statutory tax rates are similar and tax collection ratios are generally higher—a benchmarking exercise suggests that the current revenue envelope is close to its frontier. Going forward, there is a need to sustain revenue mobilization efforts, which will be instrumental to maintaining a sound fiscal position, reducing the infrastructure gap, and increasing social spending. Rationalizing large tax expenditures could contribute to these efforts.

A. Progress: Benchmarking Tax Effort

1. **Honduras has made considerable progress mobilizing revenues over the last five years.** Revenue mobilization efforts contributed significantly to the recent fiscal consolidation, which reduced the NFPS deficit by 6½ percentage points of GDP between 2013 and 2018 and has been essential to strengthen macroeconomic stability.[2] These efforts were not only noteworthy—given the large size of the informal economy in Honduras—but also coupled with a significant rightsizing of primary expenditure.[3] Moreover, they took place in the context of stable GDP growth, which is consistent with the evidence pointing to relatively low tax multipliers (compared to those from spending) and the potential for positive effects of sound fiscal consolidation on economic activity.[4] Overall, combining these two elements, a sound fiscal position has been maintained since 2015, in line with the Fiscal Responsibility Law enacted in 2016.

2. **This has helped stabilizing the fiscal position, but the need for sustaining revenue mobilization going forward persists.** Medium-term revenue mobilization is key to financing programs for poverty reduction, expanding infrastructure investment, and achieving the reduction in public debt envisaged in by the authorities' medium-term fiscal framework (MTFF). Moreover, strengthening revenue mobilization measures can secure enough fiscal space to accommodate contingent liabilities currently unaccounted in the MTFF—such as those associated with nonfinancial SOEs, public banks, or PPPs—and buttress the improvement in sovereign credit ratings that reduced external borrowing costs in recent years.

[1] Prepared by Maria Coelho, Javier Kapsoli, and Catherine Koh.

[2] Tax revenue increased by 3.3 percent of GDP during this period, mainly driven by the fiscal package enacted in December 2013—which increased the VAT rate and introduced a minimum corporate income tax. This performance was also bolstered by the creation of a new tax administration (*Servicio de Administración de Rentas*—SAR) in 2015 and the use of anti-money laundering (AML) legislation to prosecute tax fraud.

[3] Mainly through wage bill containment measures.

[4] Estevão and Samake (2013) find a small and positive tax multiplier (0.015) much lower than the spending multiplier (0.277).

Figure 1. Comparison of Statutory Tax Rates and Tax Effort Ratios

Honduras' statutory tax rates are aligned with CAPDR averages…

…but tax collection is among the highest in the region.

Sources: National authorities and IMF staff calculations

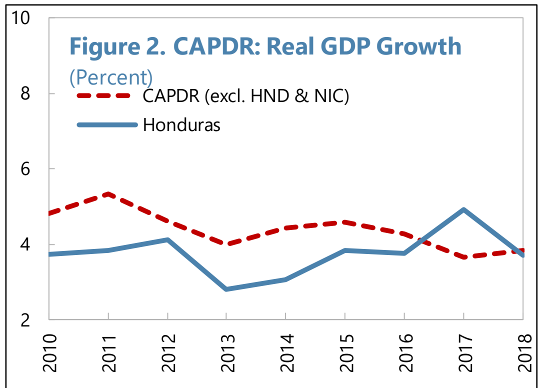
Note: Tax data displayed are 2017 or latest available data, and country aggregates (CAPDR, EM, and LAC) are calculated using simple averages. CAPDR includes Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.

3. While tax revenue collection ratios in Honduras are high, the statutory rates are aligned with regional peers. Figure 1 compares statutory tax rates and tax revenue ratios for personal income tax (PIT), corporate income tax (CIT) and value-added tax (VAT) in Honduras relative to other CAPDR, Latin America and Emerging Market countries. Across these metrics, Honduras performs remarkably well—it is the top performer among CAPDR countries in terms of revenue from corporate income and consumption taxes; and it has a relatively high collection of personal income tax. Moreover, it compares favorably against Emerging Economies, particularly in Latin America. Overall:

- *Honduras' statutory tax rates are comparable to regional peers' rates.* Figure 1 shows Honduras' sound performance in the corporate income tax, even though its statutory rate is below the CAPDR average.[5] This is explained by the minimum CIT introduced in 2013 which tax base has been severely reduced in 2018.[6]

- *The high tax collection does not seem to be hindering investment and growth.* Real GDP growth averaged 3.8 percent over 2010-18 and did not show significant signs of being affected by recent consolidation efforts (Figure 2). As for investment, Honduras was the country with the second highest private investment-to-GDP ratio in CAPDR in 2018, at 20.8 percent. During 2014-17, private investment averaged 13.3 percent of GDP. In addition, inbound foreign direct investment (FDI) flows to Honduras have outpaced the average level registered in comparators in Latin America since the early 2000s (Figure 3).

Figure 2. CAPDR: Real GDP Growth
(Percent)

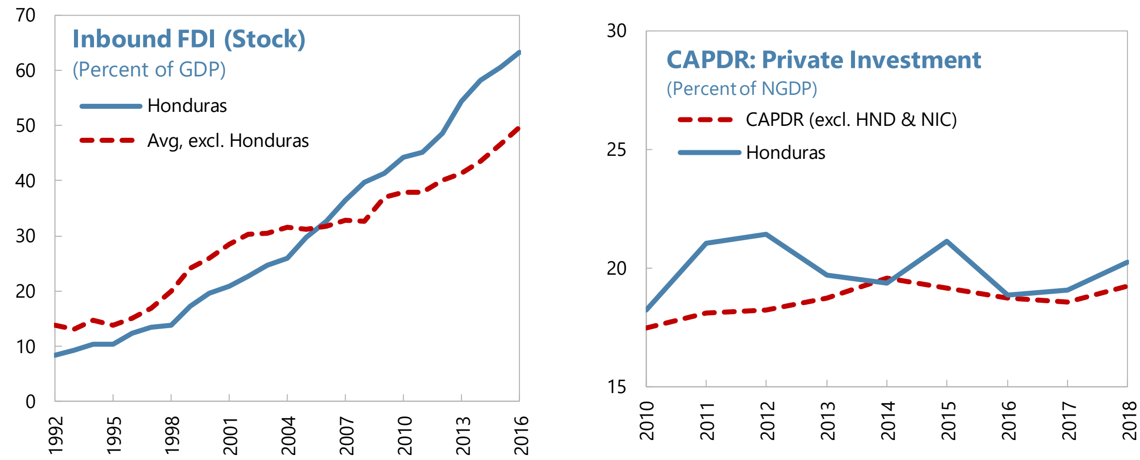


Sources: Central Bank of Honduras and IMF staff calculations.

[5] Honduras does have a marginal corporate tax rate of 30 percent for high-profit companies—the "*Aportación Solidaria*"—but it applies to only 15 percent of the whole corporate taxpayer base, contributing slightly above 10 percent of total collection.

[6] Originally all companies with gross income above half a million dollars are liable to the MIT. In 2018 this limit was increased to US$12 million and to US$24 million in 2019. Finally, in 2020 the limit will be increased to US$40 million.

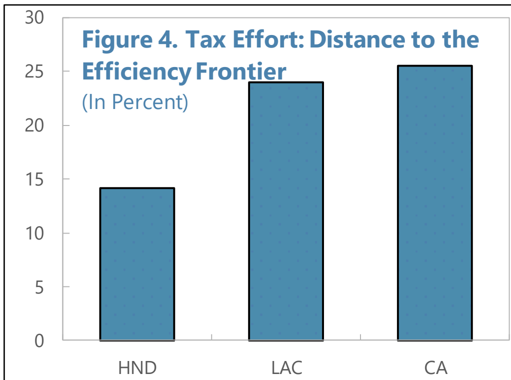
Figure 3. Comparison of Investment Trends



Sources: Central Bank of Honduras and IMF staff calculations.

4. A formal benchmarking exercise supports the evidence pointing to Honduras's relatively good collection performance. An efficiency frontier for tax revenue effort was calculated based on a model inspired on Fenochietto and Pessino (2010) and Gupta (2007). The model is a production function where the tax-to-GDP ratio is the output and education, the size of the formal economy, corruption, GDP per capita, and public spending are inputs. The efficiency frontier is structured based on the results of a set of countries that are the best performers in the sample. All other countries are then benchmarked against the frontier to measure their relative level of efficiency. As explained in Kapsoli and Teodoru (2017), for this comparison to be meaningful, countries should have similar characteristics. For this reason, the analysis is performed for 93 emerging or low-income countries. The frontier was computed by using the bootstrapped DEA approach (Simar and Wilson, 2000).[7] Figure 4 reports the findings of the exercise, which suggests that while the efficiency gap is still positive for Honduras, it is considerably lower than in Latin American countries. If all inefficiencies were removed, Honduras could increase tax collection by about 4 percentage points of GDP. As Fenochietto and Pessino (2013) pointed out, when the efficiency frontier model is used to benchmark tax effort, the efficiency gap contains not only technical inefficiency but also self-inflicted inefficiency coming from policy distortions, which in the case of Honduras is associated with tax expenditures.

Figure 4. Tax Effort: Distance to the Efficiency Frontier
(In Percent)



Source: IMF staff calculations

[7] An output-oriented model was used i.e. the efficiency score represents the proportional amount by which the tax-to-GDP ratio could be increased by leaving inputs consumption unchanged.

B. Prospects: Tax Expenditure Rationalization

5. **The authorities' future revenue mobilization strategy should prioritize reforms aiming at increasing efficiency and compliance.** Given diminishing returns from further consolidation driven by higher direct or indirect tax rates, the authorities may focus on gains from broadening the base by reducing inefficiencies in the current system (such as tax exemptions) and strengthening tax administration/enforcement mechanisms (thereby mitigating evasion). Furthermore, widespread exemptions and recent tax amnesties incentivize informality and tax evasion.[8] Therefore, anti-evasion and base broadening reforms are key to improving the efficiency and equity of the overall tax system, in addition to raising more revenue.

6. **Honduras has one of the highest levels of tax expenditures in the world—at 6.8 percent of GDP—suggesting ample scope for revenue mobilization.** As shown in Figure 5, the bulk of this expenditure is attributable to special CIT regimes and VAT exemptions. In addition to direct tax revenues forgone, multiple tax incentives also induce revenue leakage through increased avoidance and evasion opportunities. The large level of tax exemptions also favors unfair competition practices between companies with tax benefits and those that operate under the general tax regime.

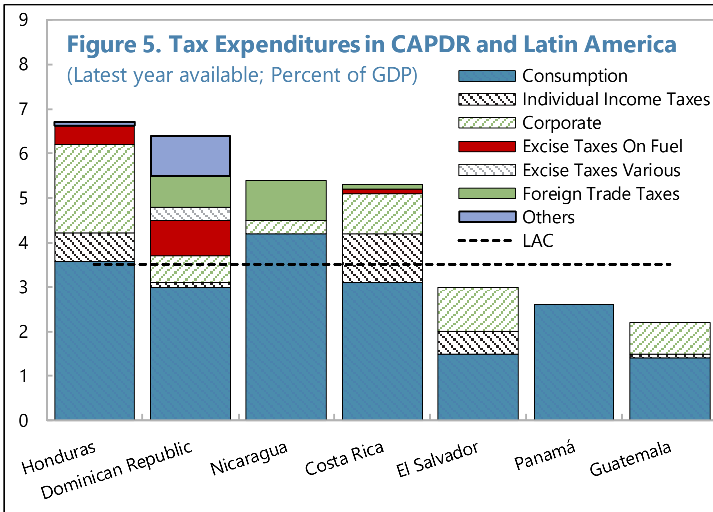


Figure 5. Tax Expenditures in CAPDR and Latin America
(Latest year available; Percent of GDP)

Sources: CIAT, SEFIN, SAR and IMF staff calculations (including Fenochietto et al (2018).

7. **The cost-benefit assessment of existing tax exemptions in terms of their policy objectives may offer guiding principles to prioritize reforms going forward.** Economic efficiency considerations point to the advantages of a reduction in tax expenditures on less elastic bases (such as fuel consumption), those with negative externalities (for example, discouraging consumption of unhealthy food items), or those with relatively small macroeconomic effects (those on higher income individuals with lower marginal propensity to consume or financially unconstrained firms that do not reinvest retained profits). In addition, several existing CIT holidays aimed at increasing exports and/or employment have failed to do so. Over the medium term, base broadening for specific types of taxes could also be instrumental to lowering corresponding statutory rates.

[8] Including the number of different tax payments required throughout the year, and the time to comply with VAT refunds and corporate income tax corrections (according to the World Bank's 2019 *Doing Business* report).

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ELECTRICITY REFORM: INTERNATIONAL EXPERIENCES[1]

This note summarizes the common components of successful electricity sector reforms aimed at improving the solvency of the sector in several countries. The note draws from case studies analyzed by FAD (2013), as well as the more recent case of Albania, which has multiple parallels with the case of Honduras.[2]

A. Key Reform Components

1. Successful reforms have pursued a three-pronged approach that focused on generation costs, efficiency gains, and a sound tariff scheme:

- *Cost reduction in the production of energy*. Opening private sector participation and liberalizing prices across the value chain in the sector can foster competition and ultimately reduce generation costs.

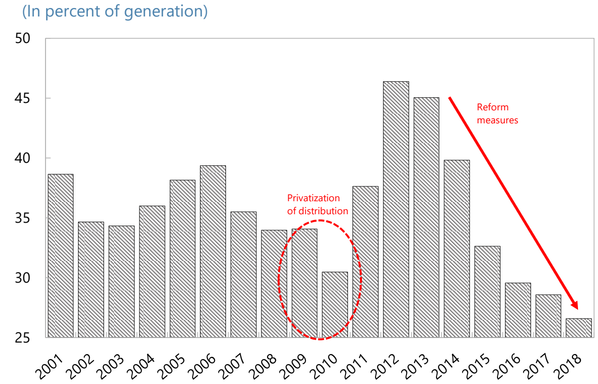
- *Reduction of distribution losses*. This is best achieved through infrastructure investment to limit technical losses, and credible enforcement threats to limit non-technical losses (illegal distribution). The latter includes criminal penalties for electricity theft, forced network disconnections, and mechanisms that reduce collusion between meter readers and consumers.

- *Cost-recovery tariffs*. Implicit and explicit subsidies were typically scaled back to guarantee operational solvency. To smooth the impact of tariff increases on the most vulnerable in society, successful reforms have been accompanied by improved targeting of social welfare programs, a single compensatory cash transfer to households at the time of the reform, and the installation of dual-rate electricity meters (enabling a lower tariff for overnight consumption within a given property). Public awareness campaigns linking payments of utility bills to more reliable service helps garner support for reforms.

B. Albania (2009-17)

2. The situation of the electricity sector in Albania before the recent reform had multiple parallels with the current situation in Honduras. A net energy importer, Albania was stricken by volatile electricity costs and inputs, marked by frequent prolonged blackouts and distribution losses that reached a high of 46 percent in 2012 (Figure 1). The state-owned electricity generation company had

Figure 1. Albania: Electricity Distribution Losses
(In percent of generation)



IMF staff calculations

[1] Prepared by Maria Coelho.

[2] Fiscal Affairs Department (2013). Energy Subsidy Reform: Lessons and Implications. International Monetary Fund.

arrears to independent power producers and the overall burden of electricity generation, transmission and distribution companies accounted for 0.9 percent of GDP in 2014. Outstanding debt of the public electricity companies stood at over 9 percent of GDP.

3. **Following the three-pronged approach described above and supported by a strong political will, Albania managed to re-establish solvency in the electricity sector.** After a failed privatization of the distribution company in 2009, the government took back control of it and put together a reform package that reduced losses by 14 percent in three years and curbed the quasi-fiscal burden of the sector to 0.1 percent of GDP in 2017. This notable transformation was achieved through a combination of short- and medium-term measures:

Short-term Measures

- Reduction of distribution losses and improved payment collection through (i) the introduction of criminal penalties for electricity theft, (ii) forced service disconnection in case of lack of payment, and (iii) provisionally fixed tariff to consumers without a meter.
- An increase in tariffs for commercial clients between 10-39 percent, and the elimination of a widely abused and subsidized lower block tariff for residential consumers. A one-off partial subsidy was given to low-voltage consumers receiving social assistance to compensate increased tariff costs.
- Removal of commercial high-voltage consumers from the regulated tariff structure, placing them in a liberalized energy market.

Medium-term Measures

- Investment in infrastructure to reduce technical distribution losses (with the support of a World Bank project).
- Supported by a sound regulatory framework, implementation of more frequent and automatic tariff updates, ensuring cost recovery.

C. Key Take-Aways for Honduras

4. **The experience in other countries suggests that a strong political will and an independent and reliable regulatory framework for the electricity sector are key to successful reforms.** Critical elements of these reforms include credible sanctions for noncompliance (including criminal penalties for energy theft), efforts to reduce technical losses, efficient generation, cost-recovery tariff updated regularly, and coverage for poor consumers through the reform period. Some experiences also suggest that privatization of distribution is complex, and it may not be effective in reducing electricity losses.

THE BUFFERING ROLE OF EXCHANGE RATE FLEXIBILITY[1]

This note discusses the benefits from greater exchange rate flexibility to support adjustment to external shocks—notably to negative terms of trade shocks. The experience in Latin American countries highlights the buffering role played by exchange rate flexibility in adjusting to shocks. This takes place through expenditure switching, as exchange rate depreciations foster exports and import substitution. Evidence of high sensitivity of exports to exchange rate movements in CAPDR countries suggests that the export side of expenditure switching is particularly strong, especially in Honduras.

A. Real External Shocks

1. Like other countries in the region, Honduras is exposed to real external shocks. CAPDR countries, and Honduras in particular, are exposed to similar terms of trade (ToT) shocks as many other Latin American countries. These shocks are typically associated with the volatility of commodity prices, with shocks for LA5 and other South American commodity exporting countries reflecting mainly variations in export prices, while in CAPDR countries they tend to be driven by fluctuations in import prices. This reflects the larger shares of commodity exports—fuels and metals—in the former groups of countries, in contrast with CAPDR exports that are more dominated by manufactures, including textiles, typically with less volatile prices. Conversely, CAPDR countries tend to have higher shares of fuel and food imports (Figure 1).

B. Exchange Rate Flexibility

2. The experiences in Latin America suggest that exchange rate flexibility can buffer external shocks, reducing their impact on international reserves and domestic demand. Chapter 3 of the May 2017 Regional Economic Outlook showed that countries with less exchange rate flexibility lose more international reserves and experience a greater compression in domestic demand and imports following negative ToT shocks. In contrast, in countries with more flexible exchange rate regimes, not only is the loss of reserves much more limited, but the stronger export recovery and import substitution triggered by exchange rate depreciation—i.e., expenditure switching effects—reduces the sacrifice ratio of falling domestic demand to support external adjustment.[2]

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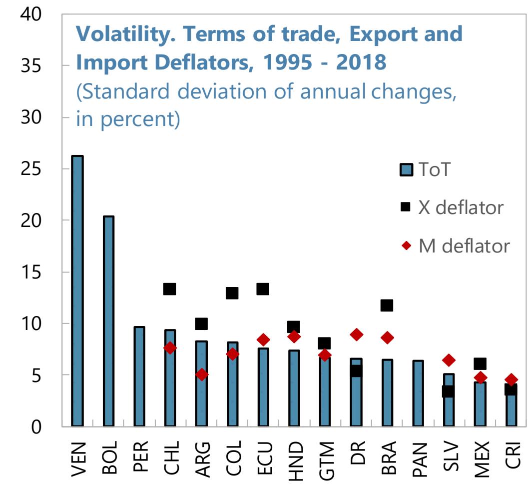
[1] Prepared by Jaume Puig-Forne and Sonia Pavon.

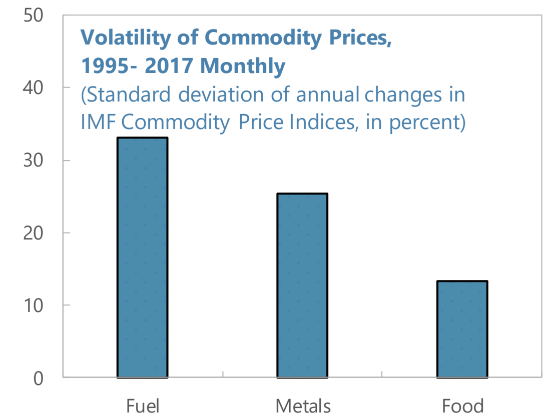
[2] The REO study focused on the response to external shocks in two groups of countries in the region: a group of commodity exporters with fixed exchange regimes (Argentina, Bolivia, Ecuador, Venezuela); and the LA5 countries (Brazil, Chile, Colombia, Mexico, and Peru).

Figure 1. Exposure to Real External Shocks in Latin America

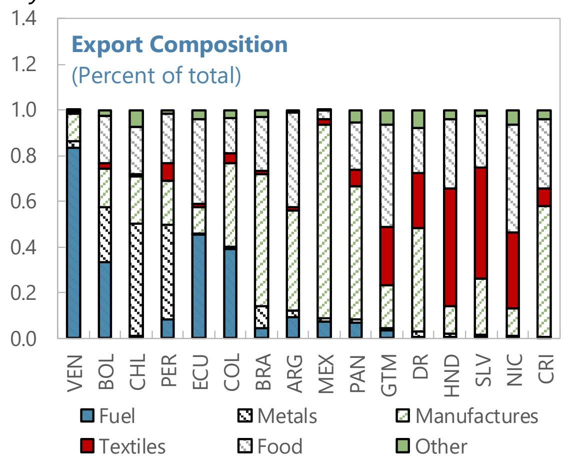
ToT shocks in CAPDR countries are similar to shocks in other countries in the region.



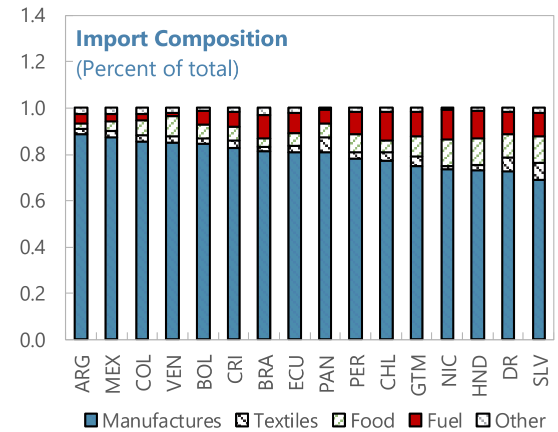
Shocks are typically associated with the volatility of prices of commodites …



… which are a dominant component of exports in many South American countries …



… and a more signficant component of imports in CAPDR countries.

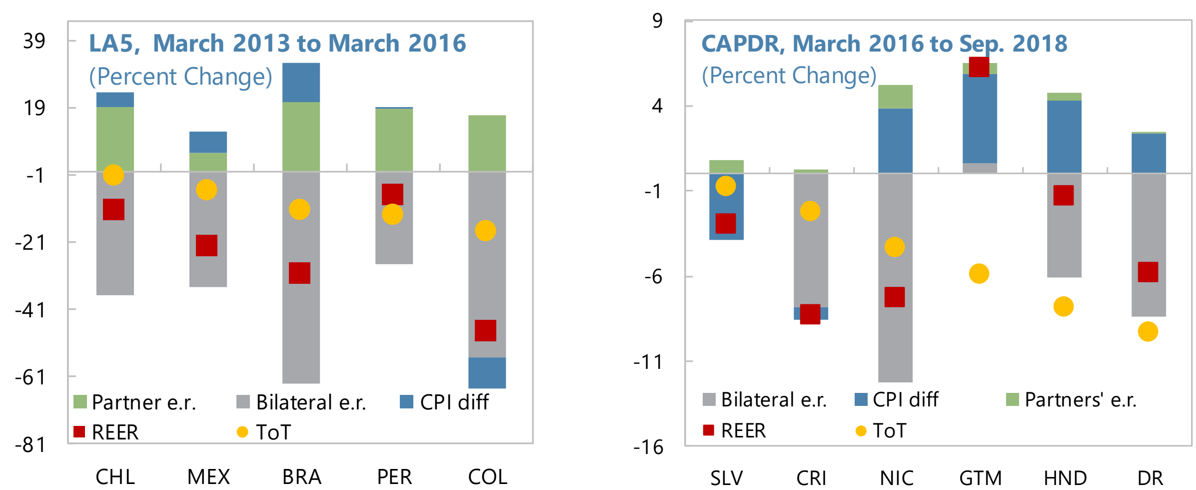


Sources: IMF's Primary Commodity Price System; WEO; World Bank's World Integrated Trade Solution; and IMF staff calculations.

3. **This evidence suggests that Honduras could benefit from greater exchange rate flexibility to buffer external shocks.** The country's crawling peg arrangement is designed to keep the multilateral real exchange rate (REER) roughly constant, as its adjustment rule aims at pairing nominal bilateral depreciations of the Lempira vis-á-vis the U.S. dollar with inflation differentials and exchange rate adjustments vis-à-vis the U.S. dollar in trading partners. The charts in Figure 2 highlight the contrast between movements in the REER during recent periods of negative ToT shocks in CAPDR, compared to countries with more flexible exchange rate arrangements. During the period of falling commodity export prices in 2013-16, LA5 countries with more flexible exchange rate regimes experienced REER depreciations that were similar or larger than the reduction in their ToT. In contrast, the REER in Honduras portrayed just a slight adjustment during the period of rising imported oil prices between 2016 and 2018, when the country experienced one of the greatest

declines in ToT in the CAPDR region. Even acknowledging that adjustments in the exchange rate may have other effects on the economy—associated with pass-throughs and balance sheet effects, which should be taken into account in the decision to move towards a more flexible exchange rate regime—this evidence suggests that Honduras could benefit from the potential buffering that expenditure switching effects may offer to external shocks.

Figure 2. Terms of Trade Changes and Contributions to REER Changes



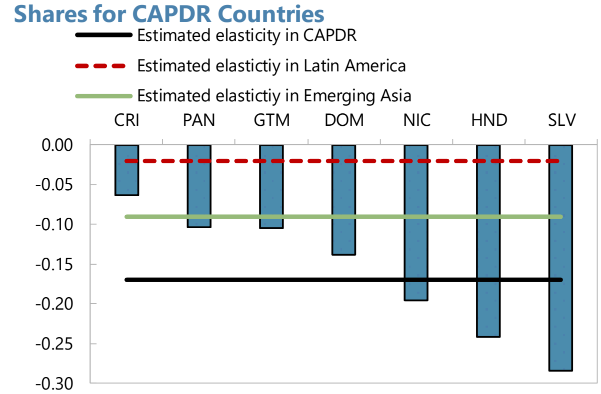
Note: Countries in each chart are ordered by the size of the terms of shock.

Sources: IMF's Information Notice System database and WEO; and IMF staff calculations.

C. Export Channel of Adjustment

4. As for the magnitude of these effects, the sensitivity of Honduran exports to the REER suggests that expenditure switching would take place through the export channel. Estimates of elasticities of CAPDR exports to the REER point to significantly larger magnitudes than in the rest of Latin America—and even emerging Asia. This result reflects the smaller role played by commodities and the larger role played by textiles in the regional export basket.[3] Elasticities would be particularly high in

Figure 3. Trade-Imputed Elasticity of Export Market Shares for CAPDR Countries



Sources: United Nations Commodity Trade Statistics Database (Comtrade); IMF Information Notice System database; and IMF staff calculations.

[3] Commodity exports are found in the literature to have lower responsiveness to REER movements than manufactures, possibly reflecting inelastic supply curves in the short-term or greater reliance on imported capital goods. Within manufactures, textile exports tend be more responsive than other more sophisticated manufacturing exports that tend to be integrated in established cross-national production structures as part of Global Value Chains (GVCs), thereby reducing their responsiveness to exchange rate fluctuations.

El Salvador and Honduras, which have the highest share of textiles in their total exports (Figure 3).[4] In the case of Honduras, a 10 percent depreciation of the REER would lead to an approximately 2½ percent increase in total exports. Additional research would be needed to assess the strength of the import substitution channel in CAPDR countries, where greater dependency on imports due to limited local productive capacity is a concern usually raised by policymakers.

[4] Implied REER elasticities of export market shares at the country level are calculated based on REER elasticities estimated by product category at the CAPDR level and on the export composition of each country.