

PROGRAM OF ESSENTIAL SOCIAL SERVICES (PROSSE)

(ME-0187)

EXECUTIVE SUMMARY

BORROWER: Nacional Financiera, S.N.C. (NAFIN)

GUARANTOR: The Government of the United Mexican States

EXECUTING AGENCIES: Secretariats of: Finance and Public Credit (SHCP); Education (SEP); Health (SSA); Labor and Social Welfare (STPS); and Social Development (SEDESOL).

AMOUNT AND SOURCE:

IDB (OC, Currency pool):	US\$ 500.0 million
IBRD:	US\$ 500.0 million
Borrower:	US\$1,000.0 million
Total:	US\$2,000.0 million

TERMS AND CONDITIONS:

Amortization period:	20 years
Grace period:	4 years
Disbursement period:	2 years
Interest rate:	variable
Inspection:	1% of the loan
Commission:	0.75% annually on undisbursed balance

BACKGROUND: Since the Peso devaluation in late December 1994, the economic prospects for Mexico in 1995 are bleak, with negative economic growth, high interest rates and the inflation rate for 1995 now estimated to be about 42 percent. Open unemployment is already increasing and likely to increase further, real wages will decline, and poverty rates will increase.

The Government of Mexico (GOM) is deeply concerned about the dual impact of increasing poverty and the reduced budgetary resources available for essential social services targeted to the poor, and is trying to strengthen existing safety net structures and protect key social service expenditures. In this context, the GOM is requesting US\$500.0 million from the IDB, and US\$500.0 million from the IBRD to protect essential social services and strengthen a low cost social safety net targeted to the poorest and most vulnerable groups.

The proposed Program of Essential Social Services (PROSSE) is recommended for financing by the two Banks for the following reasons: (i) it is consistent

with the Banks' country assistance strategy and would complement other IDB-financed projects for enhancing sustainable economic growth, poverty alleviation, and human resources development; (ii) it would provide a vehicle for rapidly transferring substantial foreign exchange to Mexico to meet fiscal crisis; (iii) it would protect essential social services and strengthen the social safety net targeted to the poor in urban and rural areas; and (iv) it would lay the foundation for efficiency gains in the high priority social sector programs in the future.

OBJECTIVES:

The PROSSE has three objectives: (i) to protect essential social services for the poor, through the provision of textbooks to all students, and on a targeted basis, teaching materials, expanding access to pre-school, primary and lower secondary education in isolated rural areas, and provision of a basic health care package, vaccines, pharmaceuticals and medical supplies, and community health outreach campaigns; (ii) strengthen existing social safety net measures, to cushion the poor from the effects of the economic crisis through retraining, the creation of short term employment opportunities for the unemployed and underemployed, and a nutrition program targeted to vulnerable groups in the poorest areas; and (iii) lay the foundation for measuring and implementing efficiency gains in the social sectors over the medium term through technical assistance.

DESCRIPTION AND COST:

The PROSSE has been designed as a time slice operation to finance ongoing high priority social sector programs within the budget allocation as of February 1995. It is the goal of the PROSSE to ensure that the essential services it has identified as priorities will be protected from future budget reductions. It consists of five sub-programs: (i) basic education services; (ii) basic health services; (iii) training and employment generation; (iv) nutrition program for vulnerable groups; and (v) monitoring and evaluation of social sector programs. In each sub-program, the GOM will seek to improve the efficiency of public expenditure, within the constraints of the budget and the two-year implementation period, using agreed monitoring and evaluation indicators.

The total cost of the project is US\$2,000.0 million of which both the IDB and the IBRD will participate with US\$500.0 million each. The IDB will finance the following: (i) Basic Education Services. US\$ 218.2 million for basic education for the poor and

basic education facilities; (ii) ReTraining and Employment Generation. US\$274.8 million for short-term employment generation in low-income urban and rural areas; and (iii) Nutrition. US\$2.0 million to help reduce maternal and child mortality, improve the nutrition status of the vulnerable groups in the poorest areas.

The proposed PROSSE would be implemented over a period of two years and is expected to be completed by December 31, 1996 and the loan account to be closed by June 30, 1997.

**ENVIRONMENTAL
CLASSIFICATION:**

The Environmental Committee (CMA), classified this operation in Category III, and the corresponding Environmental Summary was approved on May 2, 1995. The IBRD classified this program as category "B". Although no major environmental issues are foreseen, the eventual inclusion of small civil works projects, as part of the employment generation sub-program, deserves the consideration of certain precautions and measures to address the potential negative impacts. Since the eventual small civil works will be executed through the Secretaría de Desarrollo Social (SEDESOL), and should the need arise, the environmental impact of sub-projects will strictly follow the criteria and procedures already agreed with the GOM in the Municipal Development Program (Loan 837/OC-ME); and the IBRD's Second Decentralization and Regional Development Project (Loan 3790-ME).

BENEFITS:

The project would help reduce possible increases in poverty brought about by the economic recession, through preserving essential social services for the poor, providing training and employment enhancement opportunities for 800,000 unemployed and underemployed workers over the two year period through the *Programa de Becas de Capacitación de Trabajadores* (PROBECAT), plus approximately 550,000 short-term jobs for the unemployed poor through the SEDESOL Programa Especial de Empleo (PESE), providing enhanced food and nutrition supplements to women and children in priority areas. Indigenous populations will benefit in particular from the services provided under the basic education, health and nutrition components as these programs are targeted to the poorest areas where the indigenous populations are concentrated. The primary benefit of the PROSSE for the selected services and programs is that it commits SHCP and the executing agencies to support priority programs targeted to the poor.

RISKS:

The PROSSE may be subject to the following potential risks:

(a) Uncertainty regarding budgetary allocations. This is essential to the approach of the PROSSE. Mexico continues to face a high degree of uncertainty in terms of macroeconomic variables which determine the budgetary ceilings. Maintaining the February 1995 budgetary allocations in real terms for the high priority social service programs under the PROSSE has been included as a key commitment in the Government's policy statement. To this effect both Banks will do their best to monitor budgetary releases carefully during implementation. Should further unexpected cuts be necessary, then the program size and targets would need to be reduced

(b) Program diversity. This is being mitigated by concentrating upon a smaller number of agencies which already have experience with the procedures of both Banks. In financing the PROSSE by the two Banks, three principles were observed: (i) simple process, whenever possible an entire sub-program would be financed by one of the Banks in its entirety (such as the basic health services and the retraining for the unemployed with the IBRD and the short-term employment with the IDB; (ii) the experience of the agencies with either one of the financing institutions; and (iii) in the case of nutrition, the two Banks would finance equally given their intention to collaborate in a proposed co-financed nutrition project in the future. In education, both Banks have agreed to finance specific activities in order to avoid overlapping and possible conflicts related to procurement.

(c) Poor targeting and failure to make efficiency gains. All of the PROSSE supported programs are targeted to the poor to varying degrees. Targeting effectiveness will be monitored carefully during supervision and through the physical auditing arrangements. PROSSE itself, through the sub-program Monitoring and Evaluation will lay the foundation and develop methodologies to measure and incentives to increase efficiency.

(d) Poor disbursements. Disbursements could be retarded as a result of inexperience of some implementation agencies with the Banks' procurement procedures. To minimize this risk, training of procurement staff in these agencies will be organized as part of the Banks' supervision programs, and

technical assistance will be provided by staff at the Banks' country offices.

**THE BANKS'
STRATEGY:**

The proposed loan is consistent with Mexico's Socioeconomic Report (GN-1778), and the Country Programming Paper (CPP), as well as the IBRD's Country Assistance Strategy (CAS). The strategy focuses on the revival of growth, poverty reduction and human resources development, and environmental sustainability. The proposed loan is critical to the strategies of both Banks over the short and longer term. The loan is one of the six operations proposed by the Banks to respond to Mexico's current financial crisis. It provides a safety net to the most vulnerable groups affected by the crisis and helps maintain the gains achieved in social indicators in recent years. Over the longer term, this project will continue the work of both Banks in poverty reduction, and human resource development, which remain key elements to achieving growth, equity and sustainable development in Mexico.

**RETROACTIVE
FINANCING:**

The proposed PROSSE will be disbursed over the two year period 1995-96, with the target of disbursing 60 percent of these resources in the critical year of 1995. The Banks have agreed to finance retroactively up to US\$100.0 million each, to help cover eligible expenditures for equipment, books, stipends, civil works, and food, made on or after January 1, 1995, in the case of IDB, and February 19, 1995 in the case of IBRD.

PROCUREMENT:

The amounts over which public international bidding will be required will be US\$350,000 for goods and services and US\$5.0 million for works.

**EIGHTH
REPLENISHMENT
POVERTY
TARGETING:**

The proposed PROSSE is targeted to benefit low-income groups throughout the entire country. The Program thus complies with the guidelines for IDB's participation in poverty reduction and social equity programs set forth in the Report on the Eighth General Increase in the Resources of the IDB (para. 2.78).

**SPECIAL
CONTRACTUAL
CONDITIONS:**

During negotiations, agreement was confirmed on the following:

- (a) a letter of intent on budgetary policy in the social sectors, including mechanisms to protect budgetary allocations to the social sectors during the financial crisis and measures to increase efficiency (para. 2.26);

(b) the agency responsible for the execution of the PESE, namely SEDESOL, and on the operational modalities of the PESE (para. 3.17).

(c) that the GOM would release budgetary amounts in a timely manner to the executing agencies under PROSSE in 1995 in accordance with the agreed 1995 budget allocations and physical targets described in Annex 2 of the project files and that the GOM may substitute an alternative budget, satisfactory to the Banks, for the PROSSE prior to June 30, 1995 (para. 2.7);

(d) the GOM would review the results of the CONALITEG productivity study and agree on an appropriate action plan with the Banks by July 31, 1995 (para. 3.5);

(e) the Government would: (a) provide adequate annual budget allocations for PROSSE; and (b) review these allocations with the Banks during the Quarterly Reviews (para. 4.3);

(f) SHCP, NAFIN, SEP, SSA, SEDESOL and STPS would: (i) have the records and accounts for each fiscal year audited by independent and qualified auditors with a separate opinion provided on SOEs, in accordance with generally accepted auditing standards and procedures, and with the specific current understanding with the Mexican authorities; (ii) furnish to the Banks, no later than six months after the end of each year, a certified copy of the agreed audit reports; (iii) furnish to the Banks such other information concerning the records and accounts as well as the audit as the Banks would from time to time reasonably request (para. 4.21);

(g) the GOM would establish a satisfactory set of program monitoring indicators no later than December 31, 1995 and that the system be implemented throughout the remaining life of the PROSSE (para. 5.3);

IDB Conditions prior to first disbursement

(i) Signing of an agreement between Borrower and Executing Agencies to transfer resources from the loan.

Note: The Loan Contract, relating to this operation, negotiated with the Borrower, is available for consultation by the Executive Directors.

MEXICO

PROGRAM OF ESSENTIAL SOCIAL SERVICES (PROSSE)

IBRD LOAN AND PROGRAM SUMMARY

BORROWER: Nacional Financiera, S.N.C. (NAFIN).

GUARANTOR: United Mexican States.

IMPLEMENTING AGENCIES: Secretariat of Finance and Public Credit (SHCP), Secretariat of Education (SEP), Secretariat of Health (SSA), Secretariat of Labor and Social Welfare (STPS), and Secretariat of Social Development (SEDESOL).

BENEFICIARIES: The same secretariats listed above.

POVERTY CATEGORY: The PROSSE forms a central part of the program of targeted interventions to Mexico by protecting essential social services to the poor and providing a low-cost social safety net, through short-term employment generation to those adversely affected by the economic crisis and food and nutrition programs to the most vulnerable groups of the population; thus falls under the Poverty Reduction category.

AMOUNT: US\$500.0 million.

TERMS: Repayment in 15 years, including a five year grace period, at the IBRD's standard variable interest rate.

FINANCING PLAN: See Paragraph 4.3 and Table 6.

NET PRESENT VALUE: Not Applicable.

MAP: IBRD Map No.23547.

I. INTRODUCTION

1.1 Macroeconomy: Facing rapid depletion of its foreign reserves, Mexico was compelled on December 20, 1994 to allow the peso to depreciate beyond the limits of the band that it had previously defended. A currency crisis has ensued and, as a result, the economy is contracting this year. This section summarizes a more complete discussion of recent economic developments which appears in the 1995 Country Assistance Strategy being presented concurrently with this project.

- a. Causes of the Crisis. The Mexican crisis was precipitated by a year-long series of domestic and external shocks. First, with 1994 a presidential election year and the economy in recession in the second half of 1993, the Government approved an expansionary budget for 1994. Then on January 1, the Chiapas revolt erupted, followed by several other political disturbances, including the assassination of the Presidential candidate of the ruling party, which increased uncertainty about the outcome of the August presidential election. On the external front, increases in U.S. interest rates beginning in February 1994 made U.S. assets relatively more attractive than before.

The negative reaction of investors to these shocks and the peso devaluation has been sharp, reflecting both the relative vulnerability of the economy when the shocks began and the macro policy response in 1994. Since 1987, Mexico had pursued a plausible but high-risk economic strategy, the main elements of which were: (i) the use of the exchange rate as a nominal anchor, which successfully reduced inflation to single-digit levels; and (ii) an aggressive program of structural reforms, designed to attract productivity-enhancing investment and thereby strengthen Mexican competitiveness. The risk was that this exchange rate policy would cause a real appreciation of the peso, and that the current account deficit would therefore grow and have to be financed by increasing foreign capital inflows. However, the Government believed firmly that increased investment and productivity gains would improve the economy's competitiveness sufficiently to bring the current account deficit back down to a sustainable level over time.

As expected, the real exchange rate did appreciate strongly, but sufficient increases in investment and productivity failed to materialize. Further, although important structural changes were made, other reforms proceeded too slowly to have the desired impact on productivity and competitiveness. Absent rapid productivity gains, the peso appreciation made it increasingly difficult for Mexico to compete internationally, and so the current account deficit ballooned from an average of 3 percent of GDP in 1989-90 to 7 percent in 1992-94, with no indication that a decline was beginning.

Although such large current account deficits would not be sustainable in the long-term, prior to 1994 Mexico was able to rely on surging private foreign capital inflows to finance them. Then in 1994, foreign capital inflows slowed -- responding to the shocks and to growing concern over the sustainability of Mexico's economic strategy -- and fell far short of the level needed to finance the current account deficit, so that reserves declined precipitously.

- b. Government Response. Following the December devaluation, financial markets were unsettled by the Government's initial delays in announcing an economic program, and again by the limited scope of the program that was eventually announced January 3. Recognizing the need for a more comprehensive economic program, the Government announced a revised program on March 9, which included strong fiscal and monetary adjustment, a program to deal with problem banks and prevent future banking problems, and a strengthening of the social safety net, with the program supported by a large international financial package.
- c. Prospects. Although important risks remain, financial markets have begun to respond positively to the program. Mexico's macroeconomic strengths -- a competitive real exchange rate, a balanced government budget, a manageable ratio of external debt to GDP, a vigorous export sector, and NAFTA -- are permitting a delicate stabilization with a projected current account deficit of under 1 percent of GDP in 1995. (Mexico's economic program is based, correctly, on the premise that the immediate problem is largely one of short-term cash-flow, and not of insolvency, and so its first objective is to restore stability by rebuilding international confidence) The program's international financial support package will enable the Government to convert its large portfolio of short-term debt to longer maturities. Finally, the crisis has led the Government to accelerate structural reforms in the areas of infrastructure privatization, decentralization of public services, the legal and judicial systems, and the design of social programs.
- d. The key risks for medium-term economic recovery are long-standing problems that have been exacerbated by the crisis: the fragility of the banking system and the social pressures arising from rising unemployment and poverty. If not addressed adequately, either of these risks could erupt and so undermine economic recovery (and investor confidence). The proposed Program of Essential Social Services is designed to maintain and improve key social sector programs, while the proposed Financial Sector Restructuring Project strengthens the banking system. Assuming that these two risks can be contained, economic growth is expected to resume and the risks will gradually diminish.

1. Social Sectors

- 1.2 Open unemployment has already increased sharply and is likely to increase further, with estimates of up to 1 million job losses in 1995 (the unemployment rate had reached 5.3 percent by February 1995, its highest level since 1987), real wages will decline, and poverty rates will increase, particularly in urban areas. In addition, as part of the necessary adjustment measures, public expenditures have been cut sharply in real terms under the GOM's Economic Adjustment Program (Programa de Ajuste Económico), putting at risk the gains in social indicators over recent years.
- 1.3 These events may severely erode the hard sought social and economic progress that Mexico has made over the past decade: Mexico overcame the debt crisis of the 1980s and achieved sustainable economic growth after effecting a series of, oftentimes painful, structural adjustments. The previous administration introduced macroeconomic stabilization and an ambitious public sector reform program. The stabilization program lowered inflation to single digits (from 159% in 1987 to 7% in 1994) and the gross domestic product (GDP) grew at an average annual rate of 2% over the period 1989-94. The administration succeeded in re-negotiating the country's foreign debt, reducing public sector debt (from 75% of GDP in 1988, to 32% in 1993) and reducing the fiscal deficit. In addition to correcting the main economic imbalances, including controlling inflation, improvements were made in addressing social issues such as health, education and poverty reduction.
- 1.4 Facing a starkly different situation in 1995, the GOM is deeply concerned about the dual impact of increasing poverty and the reduced budgetary resources available for essential social services targeted to the poor, which would put at risk any gains in social indicators over the last few years. The GOM is trying to strengthen existing safety net structures and protect key social service expenditures. Thus social sector expenditures are expected to rise from 52.6 percent of the programmable budget in 1994 to 55.4 percent in 1995. In this context, the GOM aims to protect essential social services and strengthen a low cost social safety net through short-term employment and retraining programs and a nutrition program targeted to the poorest and most vulnerable population groups, within the limits of its existing budgetary allocations. To help finance these objectives, the GOM is requesting US\$500.0 million from the IBRD, and US\$500.0 million from the Inter-American Development Bank (IDB), to be disbursed over the two year period 1995-96.
- 1.5 This proposed Program of Essential Social Services (PROSSE) to be supported by the IBRD and the IDB would:
 - a. consolidate and complement other projects financed by both Banks for enhancing sustainable economic growth, poverty alleviation, and human resources development (Chapter II);

- b. provide a vehicle for rapidly transferring substantial foreign exchange to Mexico to meet the fiscal crisis (Chapters II and IV);
- c. protect essential social services and strengthen the social safety net targeted to the poor in urban and rural areas (Chapters II and III); and
- d. lay the foundation for efficiency gains in the high priority social sector programs in the future (Chapter III)

II. BACKGROUND AND SECTORAL OVERVIEW

A. Background

1. The Financial Crisis

- 2.1 Facing increasing pressure on the international financial markets, on March 9, 1995 the Government announced its new economic program (Economic Adjustment Program), superseding the previous program of January 3, 1995. The development of the new program is based on assumptions that in 1995 GDP will fall by 2 percent in real terms and that inflation will run at 42 percent. The main targets of the new program are to:
- a. achieve a primary budgetary surplus of 4.4 percent of GDP for 1995;
 - b. limit net domestic credit creation to a maximum of N\$10.0 billion for 1995;
 - c. achieve equilibrium in the current account after running a deficit of 8 percent of GDP in 1994; and
 - d. restructure N\$65.0 billion of outstanding debt of the private sector, representing 13 percent of the total commercial bank loan portfolio.
- 2.2 A major feature of the program is that the GOM intends to reduce public sector expenditures by 9.8 percent in real terms for 1995 as compared with 1994. This represents an additional reduction of 4.7 percent in real terms as compared with the January 1995 program. In making the expenditure cuts, the GOM will give priority to maintaining social programs. Expenditures for ongoing productive investments would also be maintained, but new investment projects would be postponed. Low priority programs would be eliminated and existing vacancies would be frozen. The existing system of subsidies would be revised.
- 2.3 On the monetary side, the GOM will continue to float the peso and let interest rates be determined by market mechanisms. The private sector and unions are to negotiate freely their wage and employment packages, subject only to meeting the minimum wage. The program stipulates a 10 percent increase in the minimum wage starting April 1, 1995, and including a 3 percent fiscal credit (reverse income tax) to those workers earning between 2 and 4 times the minimum wage. The GOM has also developed a series of financial mechanisms to protect the liquidity of the banking system and avert widespread

insolvency. These mechanisms are being supported by the IBRD and the IDB through a Financial Restructuring operation in parallel with PROSSE.

2. The Federal Budget of the Social Sectors

- 2.4 The GOM has stressed the critical importance of human capital development in economic development in both its policy statements and in its budgetary allocation decisions. Between 1988 and 1994, the GOM redirected its operating and investment budgets away from the industrial and energy sectors and towards the social sectors. In the federal programmable budget, the shares of the energy and industrial sectors shrank from 27.4 and 12.9 percent of the total budget in 1988 to 20.0 and 0.3 percent of the budget in 1994, while the share of the social sector budget climbed from 33.2 percent in 1988 to 52.6 percent in 1994 (for more details see Annex 1 in the Project Files). This reallocation allowed the operating expenditures of the social sectors to grow at an average real rate of 11.5 percent at a time when the share of total public sector operating expenditures in GDP stayed roughly constant (18.9 versus 19.2 percent) and real GDP grew slowly.
- 2.5 Even before the recent economic crisis, it was apparent that the period of major readjustment of the budget was over and, as a result, the rate of increase in social sector expenditures would depend more strongly on the rate of increase of GDP than it had in the past six years. There were no longer the same possibilities for reallocating among budgetary categories as there was in 1988 when the energy and industrial sectors were considerably larger. The pre-crisis planned budget for 1995 reflected this slowdown. The share of the social sectors in the operating budget was programmed to increase slightly from 52.6 to 55.2 percent. Partly as a result of this modest reallocation, but mainly as a result of an expected 4 percent real rate of increase in GDP, prior to the crisis the GOM planned that, in 1995, social sector expenditures would grow by 10.9 percent in real terms.

Table 2: MEXICO - Federal Programmable Budget
Billions of Current Nuevos Pesos (N\$)

	1992	1993	1994	1995 (a)	1995 (b)
Total	175.2	203.2	240.1	269.3	270.8
of which					
Total Social	88.0	107.0	126.2	148.7	149.9
Sectors					
of which					
Education	36.2	46.0	54.3	65.5	65.9
Health	26.4	30.6	32.8	37.9	38.4
Social Security	11.9	15.5	19.0	22.5	22.5
Employment	0.3	0.4	0.8	1.0	1.2
PRONASOL	6.1	7.4	9.3	10.7	10.7

Table 3: MEXICO - Federal Programmable Budget
(percent)

	1992	1993	1994	1995 (a)	1995 (b)
Social Sectors	50.2%	52.7%	52.6%	55.2%	55.4%
Percentage of Total					
of which					
Education	20.6	22.6	24.3	24.3	24.3
Health	15.1	15.1	13.7	14.1	14.2
Social Security	6.8	7.6	7.9	8.4	8.3
Employment	0.2	0.2	0.3	0.4	0.4
PRONASOL	3.5	3.6	3.9	4.0	3.9

2.6 The events since December 1994 have altered drastically these planned expenditures. In January 1995 the government prepared a new 1995 budget that incorporated a real decline of 5.1 percent in total public sector expenditures. The revised budget still maintained a real increase in the social sector budget, but reduced significantly the real rate of increase. The real rate of increase in social sector operating budget fell from 10.9 to 1.5 percent. Because the impact of the cuts fell more heavily on other sectors, the share of the social sectors in the total budget grew from 55.2 to 55.4 of the total operating budget. In current pesos, the total operating budget of the social sectors is N\$149.9 billion and the investment budget is N\$23.2 billion. The total size of the PROSSE program amounts to 7.7 percent of the total operating and investment budget of the social sectors. Further details of the federal government budget are presented in Annex 1.

2.7 In March 1995, the Government announced further cuts in spending in real terms with the objective of reducing total public sector

expenditures by 9.8 percent in real terms as compared with 1994. While social sector expenditures are to receive a high priority, and in particular the programs supported under PROSSE, the GOM is still finalizing the budgetary framework and the allocations to specific ministries and programs and will complete the exercise by June 30, 1995. The task of identifying priority programmes for the PROSSE began after the February 1995 budget cuts have been decided. Some of the PROSSE priority programs had already taken severe budget cuts. It is the goal of the PROSSE to ensure that the essential social services it has identified as priorities will be protected from subsequent budget reductions. During negotiations, the GOM confirmed to the Banks the 1995 budget allocations for the PROSSE, as included in Annex 2 in the Project Files, and would substitute any subsequent budget (if such budget is acceptable to the Banks) for the PROSSE supported programs prepared by the GOM prior to June 30, 1995 .

3. Poverty in Mexico

- 2.8 As key objective of the GOM is the reduction of poverty in Mexico. Expenditures in the social sectors are a central element in the GOM's poverty reduction strategy. In 1992, 25.4 percent of Mexico's 84 million people were living in poverty, of whom 13 million were living in conditions of extreme poverty. Although the majority of Mexico's population (73.7%) live in urban areas, extreme poverty continues to be disproportionately a rural phenomenon, whose impact is greatest on the country's indigenous people. In 1992, 56 percent of the extreme poor lived in rural areas and were engaged in agricultural activities. Poverty increased dramatically in Mexico with the onset of the 1982 macroeconomic crisis, as per capita GDP and public expenditures declined considerably. Between 1982 and 1988, real per capita GDP dropped by 10 percent from US\$4,160 to US\$3,720.
- 2.9 Since 1989, the overall economy has begun to recover and per capita GDP has risen slightly to US\$3,960 in 1992, although it still remains below its 1982 level. In addition, expenditures on health, education and poverty programs have increased sharply and the rate of extreme poverty in Mexico has declined almost to its 1984 level. Nevertheless, regional differences remain very strong, with the poverty rate in the poorest states being ten times that of richer states. The greatest differences are seen between the states of the center and north which are either industrialized or have large expanses of irrigated agriculture and those of the southeast which have little industrial development and depend on rainfed agriculture. Moreover the IBRD's analysis of the Encuesta Nacional de Ingresos y Gastos de Hogares (ENIGHs) surveys for 1984, 1989, and 1992, shows:
- a. In 1992, the poverty gap (or measure of the average percenta by which the poor's income fell short of the poverty line) was 8.3 percent, up from 7.4 percent in 1984, although an improvement over 9.2 percent in 1989.

- b. Poverty is predominantly, and increasingly over time, a rural problem - 49 percent of the poor and 84 percent of the extreme poor live in rural areas in 1992 compared 47 percent and 75 percent respectively in 1984 - whereas the rural population accounts for only 41 percent of total population.
 - c. In 1992, Mexico's Gini coefficient (measure of income inequality) was very high at 0.533, a significant increase over 1984 at 0.473.
 - d. Income is slightly more unevenly distributed in urban areas, with a Gini Coefficient of 0.493 in 1992 compared to 0.451 in rural areas - however, with a national Gini Coefficient of 0.533, it is evident that the inequality between urban and rural areas is a major determinant of overall inequality.
 - e. The bottom 5 percent of the population earns only 0.5 percent of national income, whereas the top 5 percent earns 29.5 percent of national income; similarly, the bottom quintile earns 3.6 percent and the top quintile 58.3 percent.
- 2.10 Moreover the GOM is cognizant of the impact of the financial crisis, and ensuing recession, in reducing income levels and thereby increasing poverty. Therefore the GOM is determined to strengthen its social safety net to protect the poorest within its fiscal constraints. This it intends to do through labor retraining, short-term employment generation, a rural nutrition program and formulating policies for the more effective use of resources allocated to food subsidies/ and income transfers to the poor in urban areas.

4. Government Strategy for the Social Sectors

- 2.11 The GOM strategy in the social sectors emphasizes the critical importance of human capital development in economic development and the important role of the state in interventions which have: (a) a high public goods element (e.g. preventive care for contagious diseases); (b) economies of scale (e.g. textbook printing); and (c) failures of the market (e.g. lack of service provision for the poor and marginalized). During a period of economic crisis, the key objectives of public policy in the social sectors are the following:
- a. Targeting, programs targeted to the poor will receive priority in terms of budget allocations;
 - b. efficiency, with scarce resources, the GOM wants to obtain the maximum output per unit input, redirecting resources to the most effective programs in terms of their outcomes per unit invested;
 - c. consolidation, a key element in increasing efficiency is to eliminate overlapping programs, such as in nutrition, and

concentrate resources on a smaller number of effective programs;

- d. protection, during a time of crisis, the GOM wishes to protect programs of a high socio-economic priority; and
 - e. redirection, over the medium term the GOM wishes to redirect resources to social sector programs which manifest greater efficiency as an incentive mechanism for improved performance.
- 2.12 Within education, the GOM recognizes the problems and has developed an education strategy to ensure the provision of the basic inputs required to raise the quality of instruction in the country and to ensure that all children have adequate access to basic education. This strategy is implemented through programs which: (i) deliver instructional materials, especially textbooks to all school children; (ii) provide basic school facilities and equipment; and (iii) encourage community and parental involvement in the school. Over the last six years the Government has implemented a comprehensive reform of the education sector, including the decentralization of the system.
- 2.13 Since 1991, the Banks have supported this strategy through its financing of the Primary Education I (Programa para Abatir el Rezago Educativo - PARE - Loan 3407-ME) , Primary Education II (Programa para Abatir el Rezago en Educación Básica - PAREB - Loan 3722-ME), Initial Education (Loan 3518-ME) projects and PIARE (Programa Integral para Abatir el Rezago Educativo - Loan 846/OC-ME), with aggregate financing of US\$1,135.0 million. These projects seek to increase education quality through a variety of targeted interventions in the states with the worst educational indicators, which were partly the result of the sharp decline in educational expenditures during the debt crisis of the 1980s.
- 2.14 The current financial crisis and ensuing reductions in real Government expenditures puts at risk the implementation of the Government's strategy during 1995 and 1996, including the timely execution of the Banks' financed projects. To minimize this risk and ensure continued delivery of education services, the proposed program would provide support for the most essential programs of the Government's strategy. The Secretariat of Education (SEP) and the Banks have reached agreement that these are essential programs to increase equity in access and quality. The program would support the GOM by financing selected programs of three federal agencies as follows: National Council for Educational Development (Consejo Nacional de Fomento Educativo: CONAFE), Federal School Construction Committee (Comité Administrativo del Programa Federal de Construcción de Escuelas: CAPFCE) and National Textbook Commission (Comisión Nacional de los Libros de Texto Gratuitos: CONALITEG).

- 2.15 In the health sector, the GOM strategy focuses upon interventions to reach the most disadvantaged areas in the poorest states. Efforts are being made to fulfill the mandate of the SSA to determine sector priorities, re-allocating resources from curative to preventative health interventions and transferring decision-making power from federal to state health authorities (SHAs) and health jurisdictions, respectively. The ongoing IBRD financed Basic Health Care project (PASSPA I -Loan No.3272-ME, FY90) supports these initiatives in four states 1/ and a Second Basic Health Project, scheduled for FY95, is under way to support an additional five states.
- 2.16 However, these measures, which increased federal health spending from 2.8 percent of GDP in 1988 to 4.1 percent in 1993 (accounting for 17.5 percent of total federal expenditures) 2/, have been only partially effective. Access to health services and their low quality continue to be problems, particularly in the poorer states. The effectiveness of the public health budget is impaired by institutional fragmentation, managerial weakness and duplication of services, resulting in a loss of efficiency, equity and quality.
- 2.17 The new administration intends to rationalize resource allocation, to search for alternatives to sole Government provision and financing of health services and to strengthen the role of the private sector. However, it aims to first address the basic health care problems in the poorer states in order to establish a sound basis for later launching a major sectorwide reform program. The new Government intends to deliver a cost-effective basic health care package which includes both primary health care interventions and essential clinical services, while simultaneously supporting institutional, technical and financial reform efforts aimed to improve the health conditions of 33 million uninsured and underserved poor. More specifically, it intends to support: (a) equitable access to a cost-effective package of basic health services for the uninsured and underserved; (b) decentralization of health administration and delivery, as well as improvement of technical, managerial and financing processes in the states, to improve health service effectiveness and increase the efficiency of resource use; and (c) modernization and realignment of the SSA to assume an active leadership role in the health sector. Those objectives would be accomplished by investments at local levels in accordance with criteria, previously agreed with the federal government. Under state guidance, local health jurisdictions would define risk areas and prepare annual investment programs to be financed by the federal Government as part of the compensation program. Competition and incentives would be introduced for states and local health jurisdictions to prepare the investment programs.

1/ Oaxaca, Chiapas, Guerrero, Hidalgo and the Federal District.

2/ Source: Cuenta Publica y PEF, 1993-1994 (Gasto total consolidado).

- 2.18 In employment, the GOM recognizes the critical importance of both facilitating the movement of labor from declining sectors to growing sectors as a result of the financial crisis through the Labor Retraining Program for the Unemployed (Programa de Becas de Capacitación para Trabajadores: PROBECAT), and the need to bolster the demand for employment over the short term through the creation of a Special Employment Program (Programa Especial de Empleo: PESE).
- 2.19 In view of the declining employment prospects (paras. 2.48-2.49) in the urban and manufacturing sectors, the GOM has decided re-orient the PROBECAT for at least 150,000 of the 350,000 target trainees for 1995 (this compares to training of some 50,000 displaced workers annually over the period 1988-93) by linking up basic on-the-job skills training and short-term employment generation through infrastructure rehabilitation programs, training for self-employment and training of new staff within small and medium enterprises (SME's).
- 2.20 In addition, the GOM has announced a short-term employment program to create approximately 550,000 new jobs (of six months duration) in public works programs in areas of poverty and high unemployment. The GOM announced the PESE, on March 17, 1995, at a cost of N\$1.7 billion for 1995. The main objective of the PESE is to offer temporary employment to impoverished heads of families and, therefore, improve the living conditions of those groups that suffer the most extreme conditions of poverty. The compensation level paid to beneficiaries would be set at 80 percent of the minimum wage of the appropriate zone 3/, thereby self-targeting to the poor.
- 2.21 The PESE will use the framework of the Municipal Solidarity Funds (Fondos de SOLIDARID Municipal: FSM) within the framework of National Solidarity Program (Programa de SOLIDARIDAD Nacional: PRONASOL). PRONASOL is managed by the Social Development Secretariat (SEDESOL) and funded through a single federal budget line (Ramo 26) which is combined with state funds based on the annual Social Development Agreement (CDS) signed every year by SEDESOL with each state. The FSM is well-designed for this purpose as it operates under the following principles and guidelines: (i) community participation in project selection and implementation through Solidarity Committees; (ii) poverty targeting; (iii) decentralization and shared responsibility for Solidarity programs with state and municipal governments; and (iv) sharing of program costs among the federal government, states, municipalities, and beneficiary communities.
- 2.22 In the nutrition sector, the administration of President Ernesto Zedillo announced in February 1995 a new national nutrition program

3/ The minimum wage in Mexico is set for three different geographical zones based differentials in the cost of living.

as one of the key elements of the new administration's poverty reduction program. The President committed the Government to implement highly cost-effective nutrition programs targeted to the 127 municipalities which exhibit very high poverty and nutritional risk in nine states (12 regions with the highest poverty index in these states). One of the four nutrition-food-health programs identified in this proposal is the cost-effective integrated nutrition program, based on the pilot program financed by SEDESOL and SSA, with IBRD and IDB support, in the poorest regions of three states in 1991.

- 2.23 While the economic adjustment effort is laying the basis for more equitable growth, a coherent food entitlement policy and nutrition strategy needs to be defined. The Government is currently analyzing the existing programs with the purpose of rationalizing investments, improving coordination and targeting and alleviating poverty by reaching the most vulnerable groups of the population through targeted food and nutrition interventions, or direct income transfers.

B. Program Selection Criteria

- 2.24 PROSSE is a two year time-slice operation supporting the highest priority social sector programs. The programs were selected from the sectors of education, health, employment and nutrition according to the following criteria in order of importance:
- a. poverty targeting, the programs should target either the poor (e.g. health and education) or vulnerable groups of the poor (e.g. nutrition for pregnant women and small children);
 - b. safety net, the programs should provide an element of a safety net to protect the poor from the worst effects of the crisis (e.g. employment programs);
 - c. human capital formation, the programs should contribute to maintaining or enhancing human capital; and
 - d. size, the programs should be of sufficient size to make a significant social and economic impact and to be able to absorb significant amounts of external financing.

C. Issues in the Essential Social Services Program

- 2.25 The impact of social sector expenditures on the welfare of the poor was never as positive as suggested by the rising expenditures between 1988 and 1994, nor as bleak as would appear from the likely cut in expenditures in 1995 and beyond. In the past, the increasing expenditures allowed the social sectors to recover from the sharp cuts that resulted from the 1982 crisis and to improve social indicators. However, having budgets rising significantly every year reduced the incentives to pay attention to efficiency

and cost-effectiveness. Thus, in education, health and employment substantial inefficiencies remain, some of which are detailed below.

- 2.26 The PROSSE program attempts to improve efficiency in both the short and medium term. In the short term, PROSSE creates a distinction between pre-existing programs that are included in the program and those that are judged less essential and thus excluded. This can generate a reallocation of expenditures as future budget cuts will fall on programs outside of PROSSE and secondly, even if there are not further budget cuts, SHCP would have an incentive to release funds to the PROSSE programs first because program expenditures would be reimbursed with foreign exchange. Under PROSSE, the two Banks will finance both the investment costs of the programs supported, and also the non-wage operating expenses, which would have been cut in the absence of the Banks' financial support, thereby undermining service delivery of these key programs,
- 2.27 The Banks will provide technical assistance through the loans and through supervision, in the implementation of the safety net programs, the nutrition and employment programs. In the medium term, the Banks would help support an effort to improve monitoring of outputs in the social sectors and to link performance to budgetary allocations.

1. Education

- 2.28 Mexico has assigned high priority to human capital investment as part of its economic development strategy. Since 1950 adult illiteracy has decreased from 40 percent to about 13 percent; the number of schools has more than tripled; the number of teachers has quintupled; and school enrollments have increased sevenfold as the total population increased only threefold. As a result, by 1994, 76 percent of children aged 4-5 had access to preschool education, net enrollment rate for primary education reached 98 percent and net enrollment for lower secondary reached 88 percent. In 1993, total preschool enrollment was 1.9 million children attended to by a network of 51,554 schools and about 114,300 teachers; total primary school enrollment (grades 1-6) was 14.8 million children, attended to by a network of 88,918 primary schools and about 510,800 teachers; total lower secondary enrollment (grades 7-9) was 4.2 million children attended to by a network of 20,032 lower secondary schools and about 151,000 teachers.
- 2.29 The formal education system in Mexico includes a well-designed and mainly non-formal initial education (ages 0 through 3), two-year preschool, nine years of mandatory basic education (six-year primary education and three-year lower secondary education that had recently been integrated), three or four additional years of upper secondary education, and three to six years of undergraduate and graduate university education. The public sector provides educational services for 90 percent of total enrollment. Preschool and primary education are provided in three modalities, general

preschool and primary education; bilingual or indigenous preschool and primary education, and the CONAFE (National Council for Educational Development - Consejo Nacional de Fomento Educativo) preschool and primary education models for small communities in remote rural areas.

- 2.30 In the education sector, failure to protect essential basic education (preschool, primary and lower secondary) expenditures could undermine the very high net enrollment rate of 98 percent, particularly for children in poor and isolated rural areas and indigenous populations and would prevent attainment of increased access for these groups, and improvement in the quality and efficiency of basic education. The GOM is seeking to protect investments in essential inputs to the sector, such as textbooks, so that educational quality, cognitive achievement and thus the efficiency of expenditures across the sector can be maintained, and the basic educational opportunities for the vulnerable poor can be expanded.
- 2.31 Moreover, despite recent educational achievements, there is still a problem of inadequate access for the children of the rural poor, especially indigenous children in isolated areas. The population without access to preschool, primary, and lower secondary education is characterized by extreme poverty, geographic isolation, and early entry into low-paying positions in the labor market.
- 2.32 Although management and operation of all initial, preschool, primary, lower secondary education, and teacher training institutions were transferred to the states in 1992, including annual budgetary transfers amounting to over N\$30.0 billion, the federal Secretariat of Education (SEP) still has a leadership role on: (i) preparation and enforcement of educational policy norms; (ii) curriculum development and textbook production; (iii) support of educational research; (iv) operation of the evaluation system; and (v) design and financing of compensatory and special programs for an equitable distribution of education services, especially for those states with poorer indicators of educational development. Among the most important federal programs to improve coverage and quality of education are those being carried out by CONAFE, CONALITEG, and CAPFCE of SEP.
- 2.33 CONAFE is a decentralized agency, located within SEP, charged with designing and implementing Federal Government financed compensatory education programs targeted on the poor, indigenous groups, and on children living in poor or remote rural areas. The CONAFE community school system, in which specially trained lower secondary graduates volunteer to teach in schools built and maintained by the communities themselves, has been designed to overcome the problem of constructing and staffing schools in remote areas where it is difficult to attract and retain teachers and where, given the small size of the community, it would be extremely costly to establish regular schools. CONAFE manages all basic education

expansion and improvement programs designed by SEP as part of the Compensatory Education Programs of the federal Government for educationally deprived states. The Banks are supporting these programs through the Initial Education Project (Loan 3518-ME), First and Second Primary Education projects (Loans 3407-ME (PARE) and 3722-ME (PAREB), respectively) and by the Programa Integral para Abatir el Rezago Educativo (PIARE) funded by the IDB. In addition, the PARE and PAREB projects support the States' formal education programs in smaller schools with the aid of CONAFE.

2.34 Programs currently administered by CONAFE include:

- a. The rural community primary school program started in 1973, provides schooling for children living in rural villages of under 100 population with between 5 and 19 school-age students. The program trains lower secondary school graduates to teach in facilities provided by the communities themselves. These teachers receive room and board provided by the community; receive a small teaching stipend; and, upon completion of 1-2 years of teaching, receive a scholarship to permit them to complete upper secondary schooling. The program currently serves 160,000 children in 15,000 community built schools.
- b. The rural community preschool program started in 1980. It is similar in design and operation to the rural community primary school program administered by CONAFE. These currently serves more than 55,200 preschool children in 5,330 community built preschools, each having one volunteer teacher.
- c. The migrant children program, Atención Educativa a Población Infantil Agrícola Migrante, started in 1989, now operates in about 900 locations in nine states, providing education to 8,700 children of immigrant workers.
- d. The indigenous children program, Proyecto de Atención Educativa a Población Indígena, started in 1994, provides preschool education opportunities for indigenous children living in 260 communities and provides primary schooling to indigenous children living in 600 communities.
- e. The Solidarity Schools program provides educational materials and improved school facilities to 680,000 children and 25,000 teachers located in 9,500 traditional schools in urban marginal areas.
- f. The instructor scholarship program, Sistema de Estudios a Docentes, provides financial assistance to community teachers in the rural community preschool and primary education programs to permit them to complete upper secondary schooling.

- g. The student boarding program, Financiamiento Educativo Rural that started in 1984, finances the transportation or the boarding costs of rural students who must go or live away from home because their home communities do not provide schooling opportunities.
- 2.35 CONAFE would continue implementing the above described programs in 1995. Despite this year's budget cuts, CONAFE will maintain its targets as in 1994. It will cover about 46,500 preschool students, 161,000 primary students from community schools, 215,000 students from the Solidarity schools and up to 38,400 stipends for community instructors about 25,000 fellowships for community school instructors. To guarantee these targets, PROSSE will protect the approved 1995 and 1996 budgets.
- 2.36 CONALITEG is the largest producer of textbooks in Latin America. In contrast to the serious deficiency in textbooks in most countries of the region, Mexico, through CONALITEG, produces and distributes textbooks in several subjects (mathematics, Spanish, history, science and social science) for every primary school student in the country. Textbooks on history and geography for each state and a geography atlas for Mexico are also produced. In addition, CONALITEG prints and distributes textbooks under contract with other agencies. This includes books in more than 24 indigenous languages financed under the First and Second Primary Education Projects, and books to accompany the TV secondary education program, which benefits children in grades 6-9 in rural areas who have no access to traditional secondary education. Approximately 30 percent of all textbooks and teacher guides are printed using CONALITEG's own facilities, while 70 percent are contracted out with the private sector. After printing, CONALITEG distributes books to about 1,000 warehouses around the country.
- 2.37 CONALITEG production for 1994 included a total of 134 million textbooks. The program for 1995 was to print 154 million textbooks for all levels of primary education and for preschool as part of the traditional support to basic education. However, with budget reductions for 1995, CONALITEG would be able to produce only about 98.7 million textbooks. PROSSE would ensure that CONALITEG will produce 98.7 million textbooks in 1995, and achieve the 1996 target.
- 2.38 Despite distribution problems, Mexico has done an admirable job of getting inexpensive textbooks into the hands of almost all primary school students in the country. This experience indicates the importance of the Government's long-range commitment to textbook provision, and is a clear example of a successful experience in overcoming the obstacles associated with a large-scale national free textbook program. However, the aging of CONALITEG's production facilities combined with the current budget crisis raise questions as to how textbook production and distribution could be made more cost-effective in the future in Mexico. To help

CONALITEG in finding efficiency gains a Productivity Study will also be financed under PROSSE.

2.39 CAPFCE is the federal agency charged with managing the constructing, rehabilitating, and equipping of educational facilities from preschool through university levels using private contractors. School construction needs are determined by the State Secretariat of Public Education in each state and reviewed and consolidated by SEP's General Directorate for Planning, Programming and Budgeting at the central level. Up to 1994 it had built some 640,000 classrooms or about 96,000 schools. In the last six years it constructed the equivalent to 46 classrooms per day. This agency has extensive experience in carrying out construction under IBRD- and IDB-financed projects, including the IBRD's First and Second Primary Education and the IDB's PIARE projects and the Earthquake Reconstruction and Rehabilitation project. While the states and municipalities are responsible for primary and some secondary school facilities, CAPFCE manages construction of federally-financed facilities at all levels of education, mainly in rural, indigenous and marginal urban areas. The four highest priority activities are:

- a. The preschool construction program has four subprograms serving urban, rural, and indigenous children, including one program of special education for preschool-age students with learning disabilities (Centros de Atención Preventiva para la Educación Preescolar).
- b. The general secondary education program comprises facilities for rural youth enrolled in the lower secondary education television program (telesecundaria), and facilities for youth enrolled in technical training programs. SEP has found that TV secondary education is the best cost-effective alternative to deliver secondary education services in rural isolated areas where given the small size of the students, it would be very costly to establish regular secondary schools. In 1993, the unit cost for TV secondary was about 10 percent lower than general secondary (N\$858 versus N\$935 in 1988 constant prices). TV secondary schools are one-room schools with instructional material delivered to schools by SEP through television. Despite the low student teacher ratio, the low unit cost is explained by the fact that one teacher covers all subjects. Currently 5,800 telesecundaria schools operate with about 16,000 teachers and 261,000 students. The schools often start in rented or borrowed premises and once established, move to permanent premises with the necessary laboratory and sanitary facilities.
- c. Boarding schools (albergues) for indigenous students in isolated rural areas.
- d. The maintenance program provides preventive maintenance mainly for school buildings in basic education. The

technical manual for preventive maintenance is the same one used by the First and Second Primary Education Projects financed by the IBRD and PIARE financed by the IDB.

- 2.40 CAPFCE had to reduce by 11 percent the 1995 original targets as a result of the budget cuts. The physical programs that would be protected by PROSSE include those which benefit the most educationally deprived students. PROSSE will protect CAPFCE's budget to ensure that these students, generally from poor and rural areas, will benefit from the 1995 and 1996 construction programs; whose intention is to consolidate and house existing telesecundaria schools in permanent premises. In 1995, the revised program includes the construction of 5,990 educational spaces for preschool, 1,990 for TV secondary, and 40 for indigenous boarding schools.

2. Health

- 2.41 In the health sector, further cuts in expenditure on essential health services for the poor, who rely upon the SSA, could widen the existing large disparities in health status between geographic regions and income groups. Already life expectancy stands at 55 years in rural areas, versus 71 years in urban areas; and 53 years among the poor, as compared to 73 years among the wealthy. Similarly, infant mortality ranges from 20 per 1,000 in richer states to more than 50 per 1,000 in the poorer southern states. The budget for cost-effective preventive and curative interventions targeted to the poor needs to be protected to prevent an exacerbation of these disparities, with the attendant loss of human capital and welfare.
- 2.42 Moreover, there is an unfinished agenda, as still some 33 million people live in poverty without adequate access to health and social services. Of a total population of 84 million, 25 percent (21 million) are poor and another 16 percent (13 million) are considered extremely poor, not able to meet their basic health needs. Real per capita income in the richer (mainly northern) states is more than twice that in the poorer (mainly southern) states. Urban centers and northern states have health indicators similar to OECD levels, while in urban slums, rural areas and southern states the poor are still subject to a pre-transitional epidemiological pattern, characterized by communicable diseases and malnutrition. The urban elites and the middle class are increasingly subject to a post-transitional epidemiological pattern with a higher burden of chronic diseases. These disparities place very different kinds of demands on the health services and represent a major challenge for the Mexican health care system.
- 2.43 Sector work undertaken by the GOM and the two Banks in 1994 shows that after 1988 the Government increasingly made health care a priority in its agenda. As a result, total federal health spending increased nearly 15 percent per year in real terms and reached an

estimated 4.8 percent of GDP in 1994. Overall, IMSS and ISSSTE account for 75 percent of federal health expenditure, the SSA for 20 percent, and the Armed Forces and other parastatal entities, such as the Mexican State Oil Company (Petroleos Mexicanos: PEMEX), account for the remaining 5 percent. However, spending increases have not been equitably distributed between the main providers, favoring higher and middle income classes who are covered by the public social security system. Fiscal transfers to IMSS account for some 0.5 percent of GDP, which is equivalent to the total SSA expenditures for the uninsured population. In other words, those middle and higher income population receive the same public subsidies as the uninsured low income population. Between 1987 and 1993, the budgets of the Mexican Social Security Institute (Instituto Mexicano de Seguridad Social: IMSS) increased 80 percent, the Public Sector Employees Social Security Institute (Instituto de Servicios de Seguridad Social para Trabajadores Estatales: ISSSTE) 23 percent, and the SSA 44 percent, widening the gap in public services between those already being covered by the social security system of IMSS and those not covered and attended to by SSA services. Moreover, although spending increased in the SSA, a disproportionate share of these resources are allocated to salaries and administrative costs, leaving the efficiency in public health services provided by SSA further deteriorated. Despite the increases in spending by the SSA and the social security institutes, the decline in quality of public services and increases in income levels have led to a rapid increase in private sector spending, which now accounts for 2 percent of GDP, or an estimated US\$84 per capita.

2.44 Within the health sector, the PROSSE aims to support the following efficiency gains within the operation of the SSA :

- a. Targeting of SSA. The current economic recession will increase the importance of the SSA's health services as service provider of last resort. Many employees, estimated up to 1 million, will lose their formal sector jobs and will, over the course of 1995 and 1996, augment the uninsured population dependent on services from the SSA as health provider of last resort. The budgetary protection will help the SSA to effectively use its installed capacity to provide more services for a greater number of patients, and thereby raise efficiency.
- b. Selection of preventive and basic health care programs. The PROSSE intends to protect highly cost-effective preventive programs and priority basic health interventions from budget cuts as identified by the Fundación Mexicana de Salud as the initial proposal for the basic health care package. Thus cuts in the sector would be concentrated on less cost-effective tertiary curative care and the 10 national health institutes. This segment of SSA operations will have to accommodate to a tighter budget and find additional resources through internal efficiency gains, competition for budgets or

by charging patients for sophisticated third level care services.

- c. Budget regularization. Certain priority programs, such as the immunization program or the cholera prevention program, are financed irregularly through savings under the budgetary allocations for other programs. The proposed program intends to not only protect the operation of those priority programs but also to regularize budget allocations to them and include them into the annual budget process.
- d. Competition for resources. The proposed program would introduce an element of competition for budgetary support in 1996. Programs which will not achieve their programmed objectives are at risk of not receiving of the protection program in its second year in favor of other more efficient and effective programs.
- e. Inter-state equity. Currently, the poorer states receive a lower budgetary allocation per uninsured population than the richer states. A more rational and equitable allocation system for the SSA budget will be developed and introduced under PROSSE. .

3. Employment

- 2.45 Mexico's financial crisis has already had an impact on unemployment. The formal sector of the economy is beset by three major problems: (i) a generalized reduction in domestic demand caused by the recession, although the tradables sectors will benefit from an increased external demand as a result of the devaluation; (ii) high interest rates (analysis of companies quoted on the Mexican stock exchange shows that companies in the transport, construction and non-financial service sectors have particularly high levels of indebtedness); and (iii) the impact of the devaluation of the peso for those companies holding debt denominated in foreign exchange (sectors particularly affected are transport, non-financial services and, within manufacturing, cement, machinery, transport equipment, textiles and clothing).
- 2.46 Under these circumstances, enterprises in the formal sector have started to shed labor to reduce costs and improve their short-term cash flow and there is no evidence that this trend will be reversed in the near future. Evidence of the decrease in demand for labor is as follows:
 - a. Between November 1994 and January 1995, according to IMSS statistics, 231,000 workers (2.6 percent of total employment) lost their jobs in the formal sector (according to INEGI, some 753,000 workers lost their jobs in the first two months of 1995). Of these job losses, 36 percent were in manufacturing, 18 percent in commerce, 11 percent in services

and 11 percent in construction. It is expected that another 800,000 workers will lose their jobs by the end of the year.

- b. Open unemployment rose to 5.3 percent in February 1995 -- its highest level since 1987.
 - c. According to the Encuesta Industrial Mensual, there was a contraction in employment in the 3,218 largest manufacturing enterprises of 5 percent in 1994, concentrated in industries producing intermediate goods and consumer durables.
 - d. There was a 23 percent drop in the number of vacancies listed through the employment service in Mexico City in February 1995 compared to a year ago.
 - e. Several major banks are in the process of laying off up to 30 percent of their staff.
 - f. The Federal Government is in the process of establishing downsizing targets for administrative staff, as well as implementing a general austerity program, in line with the latest round of budget cuts.
 - g. It is estimated that 2,000 restaurants and eating establishments closed during the first quarter of 1995, with a loss of some 14,000 jobs.
- 2.47 Set against the context of the need for the labor market to absorb approximately 1 million new entrants annually, the employment position in Mexico appears bleak. Open unemployment is not a viable option for most workers ^{4/} - as most workers in the formal sector are not entitled to severance pay, and there are no continuing forms of income support or unemployment insurance. Workers becoming unemployed thus either seek alternative employment in the formal sector or, particularly in times of recession, swell the ranks of the informal sector, increasing the number of under-employed and placing further downward pressure on real incomes in the informal sector.
- 2.48 Whilst it is expected that the devaluation will have a positive impact on demand in the tradables sectors (both for exports in such sectors as automobiles, transport equipment, machinery, extractive industries and metal products) and should boost the flow of tourists, the impact on demand in the labor market will take some months to be realized. In this context, there is a need for two types of shorter term interventions to bolster demand in the labor market: (i) retraining programs for the unemployed to help them

^{4/} Despite these developments, open unemployment increased only from 3.3% to 3.7% between the fourth quarter of 1993 and the same quarter of 1994. However, by February 1995, open unemployment had risen to 5.3% nationally and as high as 10.7% in Mexico City.

take advantage of new employment opportunities in growing sectors and self-employment; and (ii) short term employment programs through the rehabilitation and creation of physical infrastructure targeted to the rural and poor areas.

4. Nutrition

- 2.49 In 1988 approximately 42 percent of all children under 5 years of age in Mexico were malnourished. This level is not likely to have improved since 1988, mainly because malnutrition in Mexico is a function of poverty, infectious disease and poor feeding practices (including breastfeeding). Malnutrition is concentrated among the poorest households (defined as less than 2 minimum salaries) and in isolated, largely indigenous, rural municipalities. Although general food subsidies have been the most widespread and the most costly food program, the Mexican Government has implemented a series of targeted food and nutrition interventions to provide income transfers and other services to the poor and those who are nutritionally at risk. The targeted interventions can be classified into four categories, namely supply and price regulation programs, price subsidy programs, food distribution programs and nutrition education and consumer information programs.
- 2.50 While Mexico has historically devoted large budgetary resources for food and nutrition programs, malnutrition has not been eliminated. There are currently over two dozen nutrition programs and food subsidies in operation in Mexico, which in 1995 will cost well over US\$500 million. These are designed to help the poor covered by all food and nutrition programs (estimated to be approximately 16 million people or about 2.7 million families).
- 2.51 The main problems with the existing nutrition programs are that they fail to reach those at highest risk of malnutrition (especially in rural areas) and that there is no coordination or coherence among programs with respect to goals, targeting criteria, monitoring systems, or delivery systems. The budget for such programs is highly concentrated in urban areas, where programs overlap in coverage, and whilst in the highest risk rural areas there is a lack of coverage. Many of the national programs distribute food but the food basket delivered is highly variable with respect to commodities, nutritional value, and cost. An additional concern is that none of the programs in place at present are addressing micronutrient deficiencies: for example, iodine deficiency continues to be a problem in mountainous areas, and iron deficiency is widespread particularly among the poor. The current expenditures on food and nutrition are not cost-efficient or effective in overcoming malnutrition. The GOM recognizes that many of the reforms necessary in the nutrition sector require further study and the GOM is seeking additional program support from the Banks in the field of food and nutrition.
- 2.52 To improve the effectiveness of nutrition programs in rural areas, in 1991 the GOM implemented a pilot Integrated Nutrition Health

Program, financed by SEDESOL and SSA, with IBRD (under loan 3357-ME) and IDB support, in the poorest regions of three states. This intervention included growth monitoring, nutrition education, kitchen gardens, community public works, and a food basket delivered monthly to families with malnourished children. The project was carried out by community volunteers operating under the aegis of SEDESOL and the state Secretariat of Health. An evaluation found that the program was highly cost-effective: the per capita cost of the project was US\$20 per beneficiary (including all family members in the targeted household) or US\$85 per vulnerable individual (pregnant and lactating women and children under 5). In the more malnourished community the rate of moderate and severe malnutrition fell from 18.5 percent to 5.1 percent; in the other community the rate fell from 8.7 percent to 8.2 percent. The Government has started to carry out similar programs in a further nine states and 12 high priority regions within these states (Chiapas, Guerrero, Hidalgo, Michoacan, Puebla, Oaxaca, Veracruz, Chihuahua and San Luis de Potosi). The "scaling up" of the pilot nutrition, food and health program, with the modifications suggested by the evaluation, in these nine states will be supported by SEDESOL under PROSSE. The priority states, high risk regions and municipalities were selected through the following criteria: (i) CONAPO Poverty Index; 5/ (ii) national census of growth monitoring (children less than five years of age, 1994); (iii) health indicators; (iv) national food consumption data; and (v) health/nutrition indicators of specific nutrition deficiency studies done in Oaxaca, Puebla, Hidalgo and parts of Veracruz.

D. Lessons Learned from Past Operations

- 2.53 Many lessons have been learnt from a wide range of social sector projects which have been undertaken in Mexico. The relevant projects are summarized in Table 4.

5/ The CONAPO poverty index ranks states, jurisdictions and municipalities based on results of "principal components analysis", using the 1990 INEGI census, which takes the following variables into account: (a) population density; (b) illiteracy in population >15 years; (c) population >15 years without primary schooling; (d) sanitation; (e) percentage of households without electricity; (f) drinking water; (g) percentage of overcrowded households; (h) percentage of households with dirt floor; (i) percentage of population in localities of fewer than 5000 inhabitants; (j) per capita income of less than two minimum salaries; and (k) presence of indigenous population. The national average would receive the index "0". A composite index between 0 and 1 would be considered as "high", between 1 and 2 as "very high". A negative index (below 0) would indicate a better than national average poverty situation ("low") and would not be considered for the project.

Table 4: Lessons Learned

Sector	Project	Loan No.	FY	Loan Amount US\$ m.	Special Features Relevant to PROSSE
Health	Basic Health I	3272-ME	91	180.0	Poverty targeted basic health services.
Education	Primary Education I	3407-ME	92	250.0	Poverty targeted basic education services.
	Primary Education II	3722-ME	94	412.0	Community Involvement in basic education.
	Primary Education (PIARE)	846/ME-OC	94	393.0	Poverty targeted basic education services
Employment	Manpower Training	2876-ME	89	80.0	Retraining for the unemployed.
	Labor Market & Productivity Enhancement	3542-ME	93	174.0	Capacity building of State Employment Services.
	Technical Education & Training Modernization	3805-ME	95	265.0	Involvement of private sector in training.
	Decentralization & Regional Development II	3790-ME	95	500.0	Community involvement in civil works program. *
	Municipal Development Program	837/OC-ME	94	500.0	Community involvement in municipal programs.
	Agricultural Structural Adjustment Loan II	3357-ME	91	400.0	Effective pilot rural nutrition program.
Nutrition					

2.54 In the particular case of the IDB, the following experiences have provided a more concise understanding of the social sectors in Mexico.

2.55 The analysis of the Municipal Development Program (Loan 837/OC-ME) program provided important insights for the design of the employment program (PESE). In terms of the likely quality of the PESE projects, using the machinery of the FMS for the bulk of the program is likely to have positive effects in three areas. Firstly, the targeting can be expected to be good: the evaluation of the FMS projects showed that most of the beneficiaries were low income families. Secondly, the process of identifying and executing projects should involve pervasive community participation: the FMS machinery of municipal councils and community committees was shown to be effective in providing community level control over the use of resources. Thirdly, the technically undemanding projects envisaged for the PEE should be of satisfactory engineering quality: while the more demanding projects in the FMS (such as water and sewage) had significant engineering shortcomings, the simpler labor intensive projects were successfully executed. The principal weakness in the SEDESOL\FMS apparatus was its reluctance to carry out effectively independent evaluations of its own performance. Dissemination of good practice, and feedback to learn from errors, was therefore minimized. In the case of the PEE this lesson has been incorporated by insisting on the full time involvement of a monitoring group whose personnel is selected and financed by the Banks.

- 2.56 In the preparation of the Primary Education Program (PIARE) 846/OC-ME the GOM and IDB systematically reviewed several types of experience. The first was Mexico's lengthy history of radical educational experimentation, specifically in the design and delivery of compensatory programs by CONAFE since 1971. Four lessons were drawn. It is feasible to introduce basic education into traditional, isolated societies by recognizing traditions and the immutability of key components of a culture such as language, community relations and working through groups and individuals having the respect of the community. Secondly, education is of immediate concern to all, hence the emphasis on involving parents. Thirdly, rural education needs to be adequately resourced. Fourthly, to keep programs affordable and focussed accurate targeting and permanent evaluation are vital.
- 2.57 Mexico also looked to international experience. In the use of indigenous languages, it has examined, adopted and evaluated approaches and teaching materials for multicultural and bilingual education. Important findings emphasised the importance of content and context to language. For Non Formal Initial Education, the impact on school readiness, subsequent school performance - enrollment, repetition and academic attainment - was assessed in programs in Argentina, Bolivia, Brazil, Chile, Columbia, India, Morocco, Peru, Turkey, Netherlands, the UK and the USA (Perry Program). The Perry Study found long term benefits including higher rates of secondary, college and vocational school graduation, higher employment rates, lower rates of welfare dependance, teenage pregnancy and arrest than for a non participating control group.
- 2.58 For primary schooling, simultaneously devoting resources to teaching materials and the technical supervision of teachers has been tested in a number of countries. In Thailand, it was found that in-school supervision by trained principals brought about bigger gains in pupil performance than district level supervision but in Mexico's rural one and two teacher schools, without school principals, district level supervisory roles were adapted to fulfil the role of principal. The definition of a clear curriculum, provision of teacher's guides and the supply of pupils' materials serve to compensate for teacher deficiencies. In addition, many of the successful features of the Escuela Nueva, though not consciously modelled, have been included in the design of this program: flexible promotion practices; specially developed instructional materials; special training for supervisors and teachers and community involvement; specific training in the use of materials, study corners and reading corners; a small library accessible to the community and self monitoring of schools.
- 2.59 Finally, formal evaluations were resorted to. These show increased pupil performance in key skills in schools benefitting from three programs currently under execution with World Bank support. With

the 1990 Census, targeting in PIARE was able to be refined so that individual communities and schools can be selected according to their condition, educational performance and degree of social disadvantage. Evaluation data is proving an important tool in the design, execution and monitoring of these programmes

- 2.60 The relevant lessons which have been incorporated into PROSSE are as follows:

1. Education

- 2.61 Education Quality and Non-personnel Expenditures. The channeling of resources to non-personnel costs has been instrumental in improving the quality of primary education in targeted areas. Access to textbooks has been one of the most cost effective education inputs to increase students' academic performance. There is vast empirical evidence, including studies financed by the Primary Education Project, indicating that textbooks improve student knowledge of science, mathematics and language. PROSSE builds upon this experience by financing textbooks, infrastructure and other educational materials in rural areas.
- 2.62 Access to Basic Education in Rural Areas. Low access in rural areas is due in part by the poor living standards of the family, and by the lack of adequate schooling system and infrastructure. SEP regular services are not provided in many small rural communities, but a low cost alternative education modality, with strong community participation, have been successfully developed by CONAFE. PROSSE would expand the coverage of CONAFE programs by financing teacher stipends, for volunteers in one-teacher school who could not otherwise be appointed, leaving small communities without teachers and thus without schools. CAPFCE would finance the consolidation of existing schools, improve the quality of schooling and widen the range of subjects that existing teachers currently on the payroll of SEP are able to teach by providing their schools with laboratories and secondary facilities.
- 2.63 Targeting. The most effective way to reach the economically and educationally disadvantaged is by specifically targeting the poor. Both CONAFE and CAPFCE focus most project activities to the poorest areas of the country, thereby serving small communities, selected for their low socio-economic CONAPO indicators.

2. Health

- 2.64 The ongoing IBRD financed First Basic Health Project was the first IBRD experience with a health related project in Mexico and provided the most valuable source for lessons learned to consider for the proposed program. Accordingly, the critical evaluation of the implementation experience of this project helped to transfer positive lessons into the design of the proposed program. Positive features that are critical for the SSA to accomplish its mandate to provide health benefits for the uninsured population are:

- 2.65 Targeting. While the First Basic Health Project targeted poor states, resources often did not reach populations most in need within the state. Therefore, it is necessary to target delivery of a cost-effective basic health care package to the most disadvantaged municipalities within a poor state. This is the approach being followed under PROSSE.
- 2.66 Improve Access to Basic Health Care. The First Basic Health Project supported infrastructure rehabilitation of first level health centers and second level hospitals in order to provide an environment suitable for basic services of high quality for the uninsured. It has been demonstrated that the use factor of rehabilitated facilities increased significantly. PROSSE will continue to finance the rehabilitation of the first and second level care network to provide quality services to the uninsured.
- 2.67 Rural Staffing. Basic Health I supported the training and recruitment of community health care workers which are selected by the community where they will serve. They were utilized in the project for staffing health posts in communities where no medical doctor was available. The PROSSE will build on this experience and finance training for community health workers to serve remote communities.
- 2.68 Build Ownership in the States. Basic Health I featured institution building activities by supporting local decision-making and problem solving, decentralizing procurement of essential supplies and improving the management capacity and the management information systems at the local level. PROSSE will continue to support project states in procurement and implementation matters through the training sub-program.

3. Employment

- 2.69 Positive Impact of Training Programs and the Need for Targeting. The IBRD's experience with both pre-service and in-service training has demonstrated their positive impact both in increasing the earnings profile of trainees and meeting the needs of private and public sector skilled employees. Careful use of the selection criteria agreed under the Labor Market and Productivity Enhancement Project will be continued under PROSSE for the regular PROBECAT programs.
- 2.70 Public and Private Sector Linkages. Experience has shown that close collaboration is required between publicly funded training institutions and the private sector to ensure that course content and graduate output match employers' needs and hence employment opportunities available. PROSSE will promote a stronger linkage between public and private sector for the regular PROBECAT program.
- 2.71 Flexibility and Adaptability. The economic crisis in Mexico has focused attention on the need to shift training and education

programs away from rigid courses with a low probability of directly related employment in the formal sector thereafter. PROSSE responds to this by supporting combined basic skills and direct employment in rehabilitation programs.

- 2.72 Unemployment versus Underemployment. Experience in Mexico has shown that open unemployment is the tip of the iceberg. A more serious problem is underemployment, with the need being to increase the productivity of employees. Under PROSSE, PROBECAT will be opened up to the underemployed in both the formal and informal sector to acquire skills, enhance their productivity and obtain more secure employment.

4. Nutrition

- 2.73 Overall Program Design: The evaluation of the pilot nutrition-project conducted under the IBRD's Second Agricultural Structural Adjustment Loan (Ln. 3357-ME, AGSAL II) found that: (i) measurable results should not be expected before two years of program implementation; (ii) the program should be targeted to the places with the highest rates of malnutrition; (iii) the food basket should contain no more than a few commodities and yet address micronutrient deficiencies; (iv) implementing agencies at the state level and community levels should be clearly defined; (v) the nutrition education, including growth monitoring, needs careful design and integration with the rest of the intervention package; and (vi) the community volunteers need close supervision and monitoring. These lessons have been incorporated into the integrated nutrition sub-program to be supported under PROSSE, which will be closely monitored and objectively evaluated. A baseline survey has been included to avoid the pitfalls noted in the evaluation of the earlier program.
- 2.74 Targeting. The evaluation of the pilot nutrition project under the AGSAL II confirms that a well-targeted and executed nutrition program can have a substantially positive effect on the nutrition and health status of vulnerable population groups. PROSSE will expand this positive experience in rural areas of the poorest states of Mexico.
- 2.75 Distribution of Micro-nutrients. Experience in El Salvador, Guatemala, and the Dominican Republic suggests that fortified baked products can be highly cost-effective in addressing micronutrient deficiencies in school children in whom such deficiencies cause learning problems. Therefore, in addition to the basic food and nutrition package, PROSSE will finance pilot testing of a vitamin and mineral-enriched cookie in the school breakfast so as to better address micronutrient deficiencies in school-aged children (whilst this does not represent a safety net measure it addresses an important long-term nutritional goal).
- 2.76 Distribution System. The distribution of food to the targeted population groups requires a well established distribution system

and executing agency capable of organizing the beneficiaries to participate in the logistics of food distribution. PROSSE will utilize existing public or private networks to provide these services and, in addition, will expand it through the health services network. PROSSE will also use the network of facilities of the National Indigenous Institute in the most remote rural areas amongst indigenous populations.

- 2.77 Nutrition Education: The literature on food supplementation programs suggests that any food transfer should be accompanied by nutrition education and growth monitoring to effect behavioral change in the family and to communicate to the family about the increased nutritional needs of pregnant and lactating women and preschool children. The costs of this program are modest compared to food supplementation programs in other countries.

E. Rationale for Banks' Involvement

- 2.78 The proposed loan is consistent with the IBRD's Country Assistance Strategy (CAS) which will be discussed by the Board on June 15, 1995 and the IDB's Programming Mission Paper (PMP) to be discussed with the Mexican authorities later this year. The strategy focuses on the revival of growth, poverty reduction and human resources development, and environmental sustainability. The proposed loan is critical to the IBRD's CAS and the IDB's strategy over both the short and longer term. The loan is one of the six operations proposed by both Banks to respond to Mexico's current financial crisis. It provides a safety net to the most vulnerable groups affected by the crisis and helps maintain the gains achieved in social indicators in recent years. Over the longer term, this program will continue the work of both Banks in poverty reduction and human resource development, which remain key to achieving growth, equity and sustainable development in Mexico.
- 2.79 The IBRD and the IDB are the major institutions that have financed social sector investment in recent years and are the only institutions which can provide the magnitude of the external financial resources to support essential social service programs in Mexico during its current fiscal difficulties. The Banks have built up an in-depth knowledge of the social sectors in Mexico through their extensive operations and sector work. The Banks' experience in supporting project activities in the social sectors provides the foundation for program improvements which, although limited due to the short duration of this program, are supported under PROSSE. Moreover, the experience gained in project implementation by the executing agencies with the Banks' policies and procedures will facilitate the rapid disbursement of the loan funds, which is essential for purposes of the overall macroeconomic stabilization program.

III. THE PROGRAM

A. Program Objectives

- 3.1 The Program of Essential Social Services (PROSSE) has three objectives: (i) to protect essential social services for the poor, through the provision of textbooks to all students, and on a targeted basis, teaching materials, expanding access to pre-school, primary and lower secondary education in isolated rural areas; provision of a basic health care package, vaccines, pharmaceuticals and medical materials, and proactive community health outreach campaigns; (ii) strengthen existing social safety net measures, to cushion the poor from the effects of the economic crisis through retraining and the creation of short term employment opportunities for the unemployed and underemployed, and nutrition programs targeted to vulnerable groups in the poorest areas; and (iii) lay the foundation for measuring and implementing efficiency gains in the social sectors over the medium term through technical assistance and program monitoring.

B. Program Description

- 3.2 The PROSSE has been designed as a time slice operation to finance ongoing high priority social sector programs within the budget allocation as of February 1995. It consists of five sub-programs: (i) basic education services; (ii) basic health services; (iii) training and employment generation; (iv) food and nutrition program for vulnerable groups; and (v) monitoring and evaluation of social sector programs. In each sub-program, the GOM will seek to improve the efficiency of public expenditure, within the constraints of the budget and the two-year implementation period, using agreed monitoring and evaluation indicators. Each of these sub-programs is summarized below:

1. Sub-Program 1: Basic Education Services

- 3.3 The basic education services sub-program (total cost US\$593.4 million), to be implemented by SEP through dependent agencies, would support the Government's strategy to improve equity in access and to raise quality of basic education. The program would obtain this by increasing access to preschool, primary, and lower secondary education for the poor and the rural and indigenous children living in the most deprived and remote areas in the country; and by supporting two of the most important factors related to low quality of education, adequate physical facilities

and access to textbook in the classroom. The program would do this by providing budget support for the three federal programs described below.

- 3.4 Basic Education for the Rural Poor (US\$132.4 million or 6.6 percent of total costs), to provide schooling to rural isolated preschool- and primary education-aged children by supporting CONAFE's programs. The program would benefit 46,500 rural community preschool students; 161, 000 rural community primary school students; and provide up to 21,000 stipends for community instructors; up to 38,400 stipends for community instructors; up to 14,600 fellowships for transportation or boarding, mainly for lower secondary education students; and about 215,000 Solidarity School students. The costs of this component are entirely recurrent costs, enabling small one-teacher schools to remain open continuously
- 3.5 Textbooks for Basic Education (US\$161.5 million or 8.1 percent of total costs), to provide 91.5 million textbooks for preschool and primary education students in the country and 7 million teacher guides (32 different topics) through financing of CONALITEG in 1995, and at least the same quantities in 1996; and to support a productivity study of the cost-effectiveness of CONALITEG's production and distribution system. During negotiations, the GOM confirmed that it would review the results of the CONALITEG productivity study and agree on an appropriate action plan with the Banks by July 31, 1995.
- 3.6 Improvement and Expansion of Educational Facilities (US\$299.5 million or 15.0 percent of total costs), to support CAPFCE's 1995 program regarding: (i) construction of 5,990 educational spaces, including classrooms and support facilities, for preschool serving rural and indigenous children and children in urban marginal areas; (ii) construction and equipping an estimated 3,720 educational spaces, including classrooms, laboratories, toilets, storerooms workshops and support facilities, for TV secondary schools; and (iii) construction of 40 educational spaces for Indigenous Boarding Schools. CAPFCE program administration, infrastructure for training, building maintenance, and constructing and equipping existing technical secondary facilities will be financed by the loans. The construction referred to in (i) and (ii) above is considered simple and entirely for the replacement or extension of inadequate schools or the replacement of rented premises with purpose built structures. No new schools will be established under this sub-program. The CAPFCE component is entirely capital outlay. The program would finance the improvement of the management information system by upgrading the information linkages between the central and field offices.

2. Sub-Program 2: Basic Health Services

- 3.7 The Basic Health Services Sub-program (total cost US\$746.5 million) to be implemented by the SSA, would benefit mostly the 33 million uninsured population through the following activities:
- 3.8 Priority Preventive Programs, (US\$307.9 million or 15.4 percent of total costs) which are cost effective public health interventions, by: (i) immunizing 20 million children annually against the most common preventable diseases; (ii) control and treatment of endemic and communicable diseases; (iii) screening for early detection of diabetes, and other chronic diseases, involving over 4 million patients annually; (iv) family planning and reproductive health for about 2.5 million new users per year; (v) maternal and child health, pre-and postnatal care, benefiting about 9 million individual patients annually; and (vi) health and nutrition education and social marketing of public health programs.
- 3.9 Basic Curative Health Care, (US\$335.7 million or 16.8 percent of total costs) for the 33 million uninsured population, would be delivered through the basic health care and mobile outreach units.
- 3.10 Basic Health Infrastructure, (US\$102.9 million or 5.1 percent of total costs) civil works, equipment and maintenance for first and second level health facilities and public health laboratories scheduled to be initiated in 1995 and concluded by the end of 1996 would be undertaken by Coordinación General de Obra, Conservación y Equipamiento (CGOCE).
- 3.11 To implement the above actions, PROSSE would finance: the civil works program; the acquisition, storage and distribution of vaccines, essential drugs, medical supplies and basic equipment to the first and second level care network (i.e. health posts, health centers, jurisdictional centers and second level hospitals); community outreach and per diem and travel for supervision personnel and on a declining basis.

3. Sub-program 3: Retraining and Employment Generation

- 3.12 The employment sub-program (total cost US\$644.2 million) includes two elements: (i) retraining and stipends for 350,000 unemployed and underemployed workers in 1995 and 450,000 in 1996 through PROBECAT, managed by STPS, to enhance worker productivity and employment prospects; and (ii) short-term employment generation through infrastructure development in low income urban and rural areas through the Programa Especial de Empleo (Special Employment Program: PESE).

- 3.13 Retraining for the Unemployed (PROBECAT) (US\$225.9 million or 11.3 percent of total costs) At least 150,000 of the trainees each year would benefit from a new training modality under PROBECAT, receiving basic skills on-the-job training in areas such as plumbing, electricity, cement work plus a stipend to work in rehabilitation and public works programs in low income areas or whilst training to establish their own small businesses. The remaining trainees would follow the more traditional PROBECAT modality of training center and in-plant training. The average stipend would be for three months set at the level of 1 minimum wage (currently N\$15 to 18 per day) plus a small transport allowance. About 30 percent of the stipends would go to rural beneficiaries. These stipends represent an investment in the human capital of the individuals concerned, financing the opportunity cost of the training time, acting as an incentive for enhancing skills and, as a by-product, providing social support to the families of these low-income targeted trainees. They would be financed by the loans on a declining basis. The effectiveness of both the ongoing and new PROBECAT modalities will be evaluated through the ongoing evaluation program under the Labor Market and Productivity Enhancement Project (Loan 3542-ME).
- 3.14 PROSSE would finance the cost of training, stipends and up to 10,000 tool-kits required for on-the-job training. The cost of materials for the rehabilitation would be financed by the beneficiaries. Though the staff assigned for this task will be located within the offices of the State Employment Services (SEEs) and use their physical infrastructure, the program of stipends will be financed completely by the federal budget and the loans. In addition to the 45 state employment agencies, the SEEs will use the 48 mobile units purchased under the Labor Market and Productivity Enhancement Project (Ln. 3542-ME, FY93) for expanding the coverage to the unemployed and underemployed in small urban and rural areas.
- 3.15 Short-term Employment Program- PESE -(US\$ 418.3 million or 20.9 percent of total costs) The GOM will carefully ensure that the paid labor approach under the PEE will not undermine the longer-term community participation approaches under PRONASOL. This will be achieved in two ways: (i) through making it clear that the paid employment activities are time-bound; and (ii) by funding only certain categories of sub-projects which have a higher public goods element.
- 3.16 The budgetary allocation for the PESE will come from the states' Social Development Agreements (i.e. federal funds allocated to each of the nation's 31 states for social development programs under PRONASOL). The PESE will be coordinated through SEDESOL and utilizing the existing administrative and financial mechanisms established under the Fondos de Solidaridad Municipal (Municipal Solidarity Funds: FSM). In 1995, N\$1.2 billion (US\$200.0 million)

has been allocated to rural areas with a high poverty rate and indigenous population together with N\$500.0 million (US\$80.0 million) for urban areas with serious unemployment and poverty problems. It is anticipated that the rural component would extend beyond 1995, whilst a decision on the urban component would be taken in the light of developments in the urban labor market during 1995. PROSSE will fund the costs of the PEE in all those states not already covered under the IBRD supported Second Decentralization & Regional Development project (Loan 3357-ME). 6/

- 3.17 Eligible labor intensive activities under the PESE include construction and maintenance of rural roads, spot road improvements, cleaning of drainage canals, garbage removal, reforestation, and conservation programs for soil and water. The state and municipal governments will discuss and approve specific programs in which to invest the funds. In rural areas, each community, through the respective Municipal Council, will be directly responsible for selecting an investment program and selecting the most needy families in the area who will be employed. During negotiations, agreement was reached on the agency responsible for executing the PESE, and on its operational modality. PROBECAT will be able to train skilled laborers necessary to complement unskilled laborers for the public works undertaken.

4. Sub-program 4: Nutrition

- 3.18 Whilst the GOM recognizes the need to strengthen key social safety net measures, it is confronted by three problems: (i) highly constrained budgetary resources available; (ii) increased demand upon the safety net due to the economic crisis; and (iii) the complex institutional arrangements, and overlapping programs. Therefore, at this time the GOM is seeking external support for only those priority nutrition programs which are cost-effective and well targeted to the vulnerable population groups, such as young children, pregnant and lactating women, in the poorest states.
- 3.19 The food and nutrition sub-program (total cost US\$ 8.7 million) would be based on nutrition and health interventions to reduce maternal and child mortality, improve the nutrition status of the vulnerable groups, growth monitoring, and health and nutrition education. The program would also provide: food distribution (basic food basket containing maize flour, beans, rice and oil); and distribution of micronutrients, for about 750,000 rural families with vulnerable groups (children under age 5, pregnant and lactating women). Micronutrient supplements would be included. Iodized salt has been added to the usual minimal food basket in the

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The States included under the Second Decentralization & Regional Development Project are Chiapas, Guerrero, Hidalgo, Michoacan, Oaxaca, Puebla, Veracruz and Zacatecas.

case of Hidalgo, because of widespread iodine deficiency in the highest risk areas. To address iron deficiency, the program will deliver iron tablets along with supportive counseling to pregnant women and it will investigate better means of encouraging pregnant women to take iron pills. The community would participate in the program by assisting in the food distribution process and developing complementary activities, such as construction of latrines, improvement in water supply and housing, and establishment of vegetable gardens.

- 3.20 At the central level, SEDESOL and DIF (Desarrollo Integral de la Familia - Integrated Family Development) would be the apex organizations which would devolve to the state and municipal governments the implementation of the program. At the state level, in the case of Hidalgo, the operational responsibility would rest with state government under the coordination of the SSA. The PROSSE, through SEDESOL, will help the state and municipal governments consolidate the overlapping federal nutrition programs, direct them to the 127 highest risk municipalities, and standardize the package of nutrition/food assistance. Beginning in 1995, Hidalgo, Oaxaca, and Puebla states will begin to implement the consolidated nutrition program in the highest risk municipalities with support from SEDESOL and DIF. The state of Hidalgo in 1995 was selected as a model for this sub-program of the PROSSE, because it is in a more advanced planning stage and the state has already established the necessary agreements with the federal agencies to coordinate the nutrition interventions, thereby improving efficiency. Similar programs would be extended to the remainder of the priority states and regions in late 1995 and 1996. The nutrition program supported by PROSSE amounts to an investment of US\$20 per person per year. Approximately 5 percent of disbursements will occur in 1995, primarily in Hidalgo, Oaxaca and Puebla, with the remainder disbursed in 1996 as the other states are able to design and implement the cost-effective package.
- 3.21 A simplified set of indicators has been selected to monitor both the delivery of inputs and impact on the beneficiaries. Initially, the food would be procured by the executing agencies through the National Distributing Company (DICONSA) and then to be transferred to SEDESOL in 1995. However, to expand the programs in 1996, SEDESOL would review the mechanisms of provision, transportation and storage of food baskets to reach the remote targeted areas.

5. Sub-Program 5: Monitoring and Evaluation

- 3.22 The Monitoring and Evaluation Sub-Program (US\$2.1 million or 0.1 percent of total costs) will strengthen the capacity of SHCP to measure and monitor the outputs of social sector expenditures thereby providing the foundation for a system to increase efficiency in expenditures throughout the social sectors over the medium term. The IBRD loan will finance technical assistance to

efficiency in expenditures throughout the social sectors over the medium term. The IBRD loan will finance technical assistance to establish such a system and the costs of a program of physical audits and beneficiary assessments within the social sectors .

- 3.23 The initial stage in this process is to establish a reliable set of monitoring indicators which relate outputs (services delivered) and outcomes (improvements in welfare by beneficiaries) to a common input (actual expenditures). Unfortunately, many implementing agencies treat output indicators inadequately. Thus PROSSE will finance consultants services to establish a set of appropriate monitoring indicators for the social sectors, measure baseline data and establish a system of incentives for executing agencies to increase efficiency by linking budgetary allocations to improvements in performance. Such a system will also enable explicit decisions to be made on the poverty targeting and inter-state equity of public expenditures in such sectors as health. In order to overcome the moral hazard problem, SHCP will instigate physical audits (to measure physical outputs and relate these to financial inputs) and qualitative assessments of beneficiaries (real outcomes). Priority will be given to developing the system for these social programs likely to provide most scope for future efficiency gains, namely (i) hospital care; (ii) secondary technical education and (iii) food and nutrition programs. During negotiations, agreement was confirmed on a satisfactory program monitoring indicators to be reviewed jointly with the Banks before the end of 1995 and that the system be implemented throughout the remaining life of the PROSSE.

IV. PROGRAM COSTS, PROCUREMENT, DISBURSEMENTS AND AUDITS

A. Program Costs and Financing

- 4.1 The total program cost is estimated at about US\$2,000.0 million, of which an estimated US\$364.3 million would be foreign exchange (18.2 percent of program costs); taxes amount to about US\$159.1 million (8.0 percent of program costs). The table below summarizes the estimated costs by sub-program. Investment costs amount to 63.6 percent of total costs; recurrent costs account for 36.4 percent of total costs. Program costs were estimated at March 1995 price levels. Cost estimates for the PROSSE in 1996 were estimated by taking the real 1995 levels of the budgetary allocations under PROSSE and augmenting these by a factor of 1.8 percent to offset population growth and an additional 4 percent to provide for a modest increase in real terms. Foreign and domestic inflation rates were estimated at 2.6 percent and 42 percent per annum respectively over the period 1995-96. The exchange rate has been adjusted so as to compensate for the difference between international inflation on a US dollar base and local inflation rates. Annex 4 in the Project Files provides a detailed breakdown of program costs and financing. All program cost estimates are based on current expenditures within the public sector.

Table 5: PROGRAM OF ESSENTIAL SOCIAL SERVICES-PROGRAM COST SUMMARY
(Total Costs) (US\$ million)

	Local	Foreign	Total
A. Basic Education Services			
1. Basic Education for the Poor (CONAFE)	107.6	24.8	132.4
2. Textbooks for Basic Education (CONALITEG)	95.2	66.3	161.5
3. Basic Education Facilities (CAPFCE)	241.3	58.3	299.6
Subtotal	444.1	149.4	593.5
B. Basic Health Services			
1. Priority Preventive Programs	255.5	52.4	307.9
2. Basic Curative Services	317.7	18.0	335.7
3. Basic Health Infrastructure	75.3	27.6	102.9
Subtotal	648.5	98.0	746.5
C. Retraining and Employment Generation			
1. Retraining for the Unemployed (PROBECAT)	200.9	25.0	225.9
2. Targeted Employment Generation (PESE)	334.7	83.6	418.3
Subtotal	535.6	108.6	644.2
D. Nutrition			
1. Protecting Vulnerable Groups	6.0	2.7	8.7
E. Monitoring and Evaluation	1.5	0.6	2.1
F. FIV	0.0	5.0	5.0
TOTAL PROGRAM COSTS ^{1/}	1,635.7	364.3	2,000.0

^{1/} Includes duties and taxes estimated at about US\$159.1 million.

- 4.2 Incremental Recurrent Costs and Sustainability. The budget commitments will cover the recurring costs implicit in the PROSSE subprograms (US\$727 million, or 36% of total program cost). There will be no incremental recurrent costs after 1996 as a result of PROSSE, as the programs financed are ongoing. Over the implementation period, the efficiency gains anticipated under the monitoring and evaluation sub-program would help to increase the cost-effectiveness of the GOM's recurrent expenditures. However, the non-wage operating costs of programs supported by PROSSE would be financed by the Banks on a declining basis (from 75 percent in 1995, to 50 percent by 1996) as these key expenditures would have been cut in the absence of support by PROSSE, thereby undermining the delivery of these services. There is in the case of CAPFCE no expansion of the physical number of schools, simply the improvement and consolidation of existing schools to enable existing teachers to teach the full range of subjects in more salubrious premises.
- 4.3 Program Financing. The program would be financed by the IBRD, the IDB and the Federal Government. The Government would finance all taxes and duties, estimated at US\$ 159.1 million, and would finance US\$ 840.9 million of local expenditures, representing 42.0 percent

of program costs net of taxes and duties. The proposed IBRD and IDB loans of US\$500.0 million each would finance 50.0 percent of total program costs, or 54.3 percent of program costs net of taxes and duties. The two loans would finance 100 percent of foreign exchange expenditures and 38.9 percent of local expenditures, net of taxes. The loans would be made to Nacional Financiera, S.N.C. (NAFIN), which would make the funds available to executing agencies for the implementation of the program.

Table 6: FINANCING PLAN

	Local	Foreign	Total
	-----	US\$ million	-----
	-	-	-
Government of Mexico	1,000.0	0.0	1,000.0
IBRD	308.5	191.5	500.0
IDB	327.2	172.8	500.0
TOTAL	1,635.7	364.3	2,000.0

Program of Essential Social Services (PROSSE) (in US\$000)					
	BID	MEXICO	SUBTOTAL	BIRF/MEXIC O	TOTAL
1.BASIC EDUCATION SERVICES	218.200	189.800	408.000	185.500	593.500
1.1 Basic Education for the Poor	105.900	26.600	132.500		132.500
1.2 Textbooks for Basic Education				185.500	185.500
1.3 Basic Education Facilities	112.300	163.200	275.500		275.500
2.BASIC HEALTH SERVICES				746.500	746.500
2.1 Preventive Care				307.900	307.900
2.2 Basic Curative Services				335.700	335.700
2.3 Health Infrastructure				102.900	102.900
3. Employment Generation	274.800	139.100	413.900	230.300	644.200
3.1 Retraining for Unemployed				230.300	230.300
3.2 Short-term employment	274.800	139.100	413.900		413.900
4. Nutrition	2.000	4.100	6.100	2.600	8.700
1.1 Protecting Vulnerable Groups	2.000	4.100	6.100	2.600	8,700
5. Financial Costs*	5.000		5.000		5.000
5.1 FIV	5.000		5.000		5.000
6. Monitoring and Evaluation				2.100	2.100
T O T A L	500.000	333.000	833.000	1,167.000	2,000.000

- 4.4 In financing the PROSSE by the two Banks, three principles were observed: (i) simple process, wherever possible an entire sub-program would be financed by one of the Banks in its entirety; (ii) the experience of the agencies with either one of the financing institutions; and (iii) in the case of nutrition, the two Banks would finance equally given their intention to collaborate in a proposed co-financed nutrition project in the future. The financing arrangements for the externally funded elements of PROSSE are summarized as follows:

Table 7: FINANCING ARRANGEMENTS

	IBRD	IDB
A. Basic Education Services		
1. Basic Education for the Rural Poor		100%
2. Textbooks for Basic Education	100%	--
3. Basic Education Facilities	--	100%
B. Basic Health Services		
1. Priority Preventive Programs	100%	--
2. Basic Curative Health care	100%	--
3. Basic Health Infrastructure	100%	--
C. Employment Generation		
1. Retraining for the Unemployed	100%	--
2. Targeted Employment Generation	--	100%
D. Nutrition		
1. Protecting Vulnerable Groups	50%	50%
E. Program Monitoring and Evaluation	100%	--

B. Procurement

- 4.5 The program would finance the procurement of a diverse set of goods, works and services in selected programs in SEP, STPS, SSA, and SEDESOL. Designated executing agencies in these Secretariats will be CONAFE, CONALITEG and CAPFCE for SEP; the Directorate General for Employment (PROBECAT) for STPS; and Infrastructure Division (CGOSE -Coordinación General de Obra, Conservación y Equipamiento) as executing agency for works in SSA. Distribuidora e Impulsora Comercial CONASUPO (DICONSA), a subsidiary of the National Agency for the Distribution of Basic Goods (CONASUPO), will be conducting acquisition and distribution of food supplements for SEDESOL during 1995. Procurement under some sub-programs would be financed entirely by the IDB on a parallel basis. The IBRD and IDB would follow the same procurement procedures unless otherwise noted.

- 4.6 Due to the special characteristics of this operation, and the need to ensure rapid and timely disbursements, IBRD-financed procurement of goods and works would concentrate mostly on large contracts at the central level which could be awarded through international competitive bidding (ICB), limited international bidding (LIB) and national competitive bidding (NCB), following IBRD procurement guidelines (January 1995) and IDB's standard procedures. For small contract purchases done by STPS national shopping procedures would be used for contracts financed by IBRD, and for food supplements in IDB-financed nutrition subprograms. NCB procedures would be acceptable for goods contracts entered into between January 1 and March 31, 1995, eligible for retroactive financing. Such contracts signed after April 1, 1995 would follow the SBDs for goods and civil works agreed to between the IBRD and GOM, with such modifications as agreed by the IBRD to be necessary for the purpose of the program.
- 4.7 Civil Works. The IBRD's financing of civil works would concentrate on the SSA's health subprograms (CGOSE) and SEP's education subprograms (CAPFCE). Contracts awards would be mainly through NCB, for values not less than US\$350,000 equivalent, without restriction to foreign participation. For health subprograms financed by IBRD, contract packages awarded by CGOSE at the central level would not exceed US\$10.0 million equivalent per package; for education programs financed by IDB, contracts awarded by CAPFCE would not exceed US\$5.0 million equivalent per package. CGOSE would use the prototypes developed under the First Basic Health Project (Loan 3272-ME) for the construction of three public health state laboratories, with the necessary technical adjustments needed for each location. It would also contract out the supervision of health civil works contracts to suitably qualified consultants to ensure consistency with feasibility studies and adherence to standards during construction.
- 4.8 Goods and Equipment. Banks' financing of contracts for goods and equipment, valued equal or more than US\$350,000 would be done under ICB or LIB procedures, as applicable. For purposes of bid evaluation under ICB, domestic manufacturers may be allowed a margin of preference in accordance with Appendix 2 of IBRD guidelines. Eligible goods include: in SEP (a) paper for in-house printing of textbooks by CONALITEG (for its 1996 printing needs, CONALITEG would provide flexibility in its bidding procedures to allow split contract awards based on best price combination to meet paper needs) and (b) printing services in CONAFE's and CONALITEG's subprograms; in SSA: (a) medical equipment and instruments; (b) miscellaneous office equipment and furniture; (c) laboratory equipment for three public health laboratories; (d) assorted inputs for the local production of vaccines by the Gerencia General de Biológicos y Reactivos (GBR); and (e) vaccines not produced by the GBR; (f) medical supplies; and (e) printing and reproduction informational materials (printed and audiovisual). Contracts under NCB procedures would be financed by

Banks for eligible services of (a) storage, packaging and distribution services for medical supplies, pharmaceuticals and vaccines in SSA and educational materials for SEP. National shopping procedures would be used by STPS to procure tool kits for trainees in the on-the-job training modality under PROBECAT.

- 4.9 Food Supplements. In the nutrition subprograms financed by IBRD in 1995, given the limited quantities required (US\$6.8 million equivalent) and the transportation, storage and distribution constraints in the three selected states, food supplements in the basic food basket (consisting of beans, corn flour, salt, sugar and cooking oil) would be carried out within the scope of the food procurement agreement between SEDESOL and DICONSA, ensuring that such procurement methods do not restrict foreign participation. However the Banks' financing of such food supplements for 1995 purchases would not exceed the average international price for each item, as referenced by an index for such commodities, acceptable to the Bank, for the month when purchases occur. During negotiations, the GOM confirmed that in 1996, such foods supplements would be procured through competitive bidding practices following procedures satisfactory to both Banks, without restriction to foreign participation .
- 4.10 Technical Assistance. Individual consultants and consultants firms carrying out technical assistance for the program, including monitoring and auditing services, feasibility studies and supervision of works under the SSA sub-program, would be hired following IBRD Guidelines for the Use of Consultants by World Bank Borrowers and by the World Bank as Executing Agency (August 1981) and IDB's Standard Procedures for Consulting Services. During appraisal, technical assistance required to support the programs financed by the program were reviewed and agreed with each executing agency. For contracting studies financed by the IBRD, all executing agencies would use a standard invitation package and contracts, amended as required for the purpose of the program. During appraisal, it was agreed that for contracts with individual consultants and firms, the program would use the standard invitation packages and contracts agreed by the IBRD for Mexico.

Table 8: PROCUREMENT METHOD - IBRD

(Millions of US\$)

Category	ICB	NCB	Other	N.B.F.	Total
Works	-	600.2 (28.9)	-	67.6	667.8 (28.9)
Educational Materials	71.7 ⁽¹⁾ (50.0)	75.2 ⁽²⁾ (53.4)	-	-	146.9 (103.4)
Pharmaceut., Medical Supplies and Food Suppl.		22.7 ⁽³⁾ (8.8)	204.8 ⁽⁴⁾ (79.7)	-	227.5 (88.5)
Other Goods & Equipment	23.1 (6.0)	3.4 (1.7)	10.6 ⁽⁵⁾ (8.2)	25.1	62.2 (15.9)
T.A and Studies			19.1 (10.4)	-	19.1 (10.4)
Remunera- tion for Temp. Fixed Term Staff			39.8 (28.8)		39.8 (28.8)
Training and Stipends (6)	-	-	312.0 (154.0)	-	312.0 (154.0)
Operational Expenses	-	101.6 ⁽⁷⁾ (45.3)	59.2 ⁽⁸⁾ (24.8)	465.3	626.1 (70.1)
Total:	94.8 (56.0)	900.1 (138.1)	645.5 (305.9)	558.0 (0.0)	2,101.4 (500.0)

* Figures in parentheses are the respective amounts financed by the Bank.

(1) Includes US\$69.7 million equivalent for textbooks by CONALITEG, and US\$2.0 million equivalent for printing of information materials for health programs.

(2) Includes US\$63.1 million equivalent for contracts awarded by CONALITEG under retroactive financing and US\$9.3 million equivalent, for transportation, warehousing and distribution of textbooks and US\$2.8 million equivalent for printing of information materials for health programs.

(3) Includes financing of contracts for transportation, warehousing and distribution of US\$11.9 million equivalent for pharmaceuticals and medical supplies, and US\$10.8 million equivalent for food stuffs procured in 1996.

(4) Includes US\$107.3 million equivalent for LIB for pharmaceuticals, and US\$94.0 million equivalent for LIB for food supplements and US\$3.5 million equivalent for acquisition and distribution of food stuffs by DICONSA in 1995.

(5) Includes US\$11.5 million equivalent under LIB for medical equipment.

(6) Does not involve procurement

(7) Includes contracts for office supplies, surgical gloves, operating gowns and related protective gear.

(8) Includes US\$44.1 for service contracts of maintenance of equipment and infrastructure.

NBF Amounts not financed by either of the Banks.

4.11 Other Costs Not Involving Procurement. Approximately 15.8 percent of program costs or approximately US\$ 315.2 million equivalent,

would not involve procurement. These costs include operational expenses, and stipends and training (which would be contracted to public and private sector training institutions in the same manner as the Labor Market and Productivity Enhancement project), as well as travel and per diem expenses in programs financed by both Banks.

- 4.12 Review by the IBRD. Prior review by the IBRD would be required for (a) all annual procurement plans done by each executing agencies, (b) procurement procedures and documentation for all tender packages and contracts for ICB and LIB and all tender package and related contracts for NCB above US\$1.0 million equivalent. In addition, the IBRD would review all supporting documentation for contracts for goods valued at above US\$350,000 equivalent, entered into during the period allowed for retroactive financing. It is expected that these prior review arrangement would result in about 65% review of IBRD -financed contracts. All terms of reference for technical assistance and studies would be subject to ex-ante review by the IBRD. Documentation for contracts with consultants' firms, valued above US\$100,000 equivalent and for individual consultants, valued above US\$50,000 equivalent, would be reviewed ex-ante by the Banks. Other contracts under these thresholds would be reviewed by NAFIN under the limite autonomo procedures agreed with the Bank. During appraisal it was agreed that procedures for prior and ex-ante review would be followed by all executing agencies. Post review would be applicable for all contract documentation retained by all executing agencies, to be done by subsequent examination by IBRD supervision missions.
- 4.13 Prior Review by IDB. IDB reserves the right to review all supporting documentation for contracts for goods valued at above US\$350,000 equivalent, and contracts for works valued at above US\$5.0 million, entered during the period allowed for retroactive financing.
- 4.14 Procurement Supervision. Detailed procurement and disbursement procedures are already included in the operating manuals in the SEP, SEDESOL, STPS, SSA and SEDESOL, where other programs financed by both Banks are under execution. NAFIN would support their actions with experienced staff in procurement procedures of both Banks. All executing agencies have experienced staff in-house who can be called upon to provide advise and/or supervise the preparation of bidding programs and packages, and ensure compliance with agreed procurement procedures during implementation. Each executing agency would be responsible of the maintenance of the program records for the review of both Banks (prior and ex-post).

Table 9: TOTAL PROCUREMENT BY AGENCY*
(US\$ million)

Category	SEP	STPS	SSA	SEDESOL	SHCP	Total
Civil Works	198.0	-	68.9	400.9		667.8
Goods						
Medical Equipment	-	-	13.4	0.5 ⁽¹⁾		13.9
Other Goods	40.0	2.0	6.0			48.0
Educational Materials	142.1	-	4.8			146.9
Training and Stipends	97.2	210.2		4.6		312.0
Technical Assistance & Studies	8.0	5.9	0.6	0.1	2.1 ⁽²⁾	16.7
Remuneration for Temp. Fixed-term Staff	0.4	0.0	39.4	0.0	0.0	39.8
Pharma-ceuticals and Medical Supplies			114.4			114.4
Food Supplements				113.0		113.0
Total:	483.0	216.8	249.0	515.4	21.0	1,485.2

* This represents all procurement, regardless of financier.

⁽¹⁾ Small quantities of newborn/infant scales along with special equipment for monitoring nutrition status of pregnant women will be purchased under the nutrition sub-program.

⁽²⁾ This would be used for the monitoring and evaluation sub-program.

4.15 **Country Procurement Assessment.** No recent Country Procurement Assessment on Mexico is available. However, Mexico's procurement regulations (Ley de Adquisiciones y Contrataciones, December 1993) clearly authorizes, as a special provision, application of procurement procedures of international financial institutions in the procurement of works, goods and services, where financing of such procurement comes from international financial institutions.

Table 10: PROCUREMENT METHOD - IDB
(Millions of US\$)

Category	ICB	NCB	Other	N.B.F.	Total
Works	-	600.2 (342.5)	-	67.6	667.8 (342.5)
Educational Materials	71.7 ⁽¹⁾ (1.3)	75.2 ⁽²⁾ (0.2)	-	-	146.9 (1.5)
Pharmaceut., Medical Supplies and Food Suppl.		22.7 ⁽³⁾ (2.9)	204.8 ⁽⁴⁾ (26.3)	-	227.5 (29.2)
Other Goods & Equipment	23.1 (12.5)	3.4	10.6 ⁽⁵⁾ (0.2)	25.1	62.2 (12.7)
T.A and Studies			19.1 (5.7)	-	19.1 (5.7)
Remuneration for Temp. Fixed Term Staff			39.8 (0.3)		39.8 (0.3)
Training and Stipends (6)	-	-	312.0 (84.6)	-	312.0 (84.6)
Operational Expenses	-	101.6 ⁽⁷⁾ (8.5)	59.2 ⁽⁸⁾ (10.0)	465.3	626.1 (18.5)
FIV			5.0 (5.0)		5.0 (5.0)
Total:	94.8 (13.8)	900.1 (354.1)	645.5 (132.1)	558.0 (0.0)	2,101.4 (500.0)

* Figures in parentheses are the respective amounts financed by the Bank.

(1) Includes US\$69.7 million equivalent for textbooks by CONALITEG, and US\$2.0 million equivalent for printing of information materials for health programs.

(2) Includes US\$63.1 million equivalent for contracts awarded by CONALITEG under retroactive financing and US\$9.3 million equivalent, for transportation, warehousing and distribution of textbooks and US\$2.8 million equivalent for printing of information materials for health programs.

(3) Includes financing of contracts for transportation, warehousing and distribution of US\$11.9 million equivalent for pharmaceuticals and medical supplies, and US\$10.8 million equivalent for food stuffs procured in 1996.

(4) Includes US\$107.3 million equivalent for LIB for pharmaceuticals, and US\$94.0 million equivalent for LIB for food supplements and US\$3.5 million equivalent for acquisition and distribution of food stuffs by DICONSA in 1995.

(5) Includes US\$11.5 million equivalent under LIB for medical equipment.

(6) Does not involve procurement

(7) Includes contracts for office supplies, surgical gloves, operating gowns and related protective gear.

(8) Includes US\$44.1 for service contracts of maintenance of equipment and infrastructure.

NBF Amounts not financed by either of the Banks.

C. Disbursements

- 4.16 The proposed program would be partially financed by a IBRD loan of about US\$500.0 million and an IDB loan of US\$500.0 million to be disbursed over the two year period 1995-96, with the target of disbursing 60 percent of these resources in the critical year of 1995 . By financing and strengthening existing programs both implementation and disbursements will be accelerated. The PROSSE is expected to be completed by December 31, 1996 and the IBRD and IDB loan accounts are expected to be closed by June 30, 1997.
- 4.17 Retroactive financing of up to US\$200.0 million equivalent (US100.0 million from both the IBRD and IDB, amounting to 20 percent of each total loan amount) would be provided to help cover eligible expenditures for civil works, equipment, goods, pharmaceuticals, medical supplies, technical assistance and studies, training and stipends made on or after February 19, 1995 (in the case of the IBRD) and January 1, 1995 (in the case of the IDB).

Table 11: WITHDRAWALS OF THE PROCEEDS OF THE IBRD LOAN

Category	Amount of the Loan Allocated (in US\$ million equivalent)	% of Expenditures To Be Financed
1. Civil Works.	26.0	85% for 1995, 50% for 1996
2. Goods & Equipment		
a. Educational Materials	98.0	85%
b. Pharmaceuticals, Medical Supplies & Food Supplements	60.0	85% for 1995, 50% for 1996
c. Other Goods and Equipment	14.0	85%
d. Food	3.0	85% for 1995, 50% for 1996
3. TA and Studies	10.0	100%
4. Remuneration for temporary Fixed Term Staff	25.0	100% for 1995, 75% for 1996
5. Training & Stipends	166.0	100% for 1995, 75% for 1996
6. Operational Expenses	63.0	85% for 1995, 50% for 1996
7. Unallocated	53.0	
Total	500.0	

Table 12: ESTIMATED IBRD DISBURSEMENTS TIMETABLE

	IBRD Fiscal Year		
	1995	1996	1997
Annual	100.0 ^{1/}	300.0	100.0
Cumulative	100.0	400.0	500.0

^{1/}Includes an initial Special Account deposit of US\$100.0 million. Retroactive financing of up to US\$100.0 million would be permitted for eligible expenditures incurred since January 1, 1995.

Table 13: WITHDRAWALS OF THE PROCEEDS OF THE IDB LOAN

Component/Subcomponent		IDB
1. Basic Education		
1.1 Basic Education for the Poor		105.9
1.2 Textbooks for Basic Education		0.0
1.3 Basic Education Facilities		112.3
SUBTOTAL		218.2
2. Basic Health		
2.1 Preventive Care		0.0
2.2 Basic Curative Services		0.0
2.3 Health Infrastructure		0.0
SUBTOTAL		0.0
3. Retraining and Targeted Employment Generation		
3.1 Retraining for the Unemployed		0.0
3.2 Targeted Employment Generation		274.8
SUBTOTAL		274.8
4. Nutrition		
4.1 Protecting Vulnerable Groups		2.0
5. Financial Costs		
5.1 F.I.V.		5.0
6. Monitoring and Evaluations		0.0
TOTAL		500.0

Table 14: ESTIMATED IDB DISBURSEMENTS TIMETABLE

	IDB Fiscal Year		
	1995	1996	1997
Annual	100.0 ^{1/}	300.0	100.0
Cumulative	100.0	400.0	500.0

^{1/}Includes an initial Special Account deposit of US\$100.0 million. Retroactive financing of up to US\$100.0 million would be permitted for eligible expenditures incurred since January 1, 1995.

- 4.18 Proceeds of the proposed loan would be disbursed against expenditures to be presented to the IBRD and fully documented for civil works, goods and equipment contracts of US\$350,000 or more, for consultant contracts with individuals of US\$50,000 or more and with firms of US\$100,000 or more, subject to prior review as per para. 4.10. Claims for expenditures under contracts below those amounts and other expenditures not covered by a contract, such as stipends, training costs, operational expenses, travel allowances, etc. would be disbursed against presentation of Statements of Expenditure (SOEs), for which the supporting documentation would be retained by the executing agencies for periodic inspection by the IBRD and by external auditors.
- 4.19 In the case of the IBRD A Special Account in U.S. dollars with authorized allocation of US\$100.0 million would be established at the Banco de Mexico. Normal documentation requirements apply, except that in addition, a copy of the bank statement from the institution holding the account detailing the transactions made and reconciled by the borrower would accompany each replenishment request. The IDB would likewise make a special advance of US\$100.0 million.
- 4.20 Disbursement Procedures. Each executing agency, with the technical support from NAFIN, would prepare the necessary documentation for prompt disbursement from the Special Account. Under a payment system recently implemented by SHCP, NAFIN would also provide funds for direct payments to contractors through the private banking system. NAFIN would be in charge of overall coordination, logistical support and field supervision of the program.

D. Accounts and Audits

- 4.21 All executing agencies and NAFIN would maintain records and accounts adequate to reflect, in accordance with sound accounting practices, the resources and expenditures in connection with the execution of the program. These records would reflect the resources and expenditures in connection with the execution of the entire program. During negotiations, agreement was confirmed that SHCP, NAFIN, SEP, SSA, SEDESOL and STPS would: (i) have the records and accounts for each fiscal year audited by independent and qualified auditors with a separate opinion provided on SOEs, in accordance with generally accepted auditing standards and procedures, and with the specific current understanding with the Mexican authorities; (ii) furnish to the Banks, no later than six months after the end of each year, a certified copy of the agreed audit reports; (iii) furnish to the Banks such other information concerning the records and accounts as well as the audit as the Banks would from time to time reasonably request. For all expenditures with respect to which withdrawals from the Loan

Account were made on the basis of SOEs, and for all expenditures with respect to which withdrawals were made from the Special Account, the executing agencies would upon request provide to NAFIN all records and accounts necessary to allow the timely performance of its obligations, and to the independent auditors, both the records and the supporting documentation.

V. PROGRAM IMPLEMENTATION

A. Program Implementation

- 5.1 The program would be overseen by SHCP through the existing Technical Committee for Budget Integration (Comite Tecnico de Integracion Presupuestal: COTEIP). The COTEIP is chaired by SHCP (Politica Presupuestal) and includes NAFIN, other elements of SHCP (such as Organismos Internacionales) and would include high-level representatives of the other PROSSE implementing agencies for this purpose. COTEIP will monitor overall implementation and oversee the process of physical and financial auditing of PROSSE activities as a means of laying the foundation for future efficiency gains in social sector expenditures. SHCP (Politica Presupuestal) would ensure that the budgetary resources for the programs supported by the PROSSE would be released in a timely manner. NAFIN would be responsible for ensuring that the executing agencies adhere to the Banks' procurement guidelines and that the requisite documentation is prepared promptly for disbursement by the Banks. SEP, together with its subsidiary organizations - CAPFCE, CONALITEG and CONAFE - will implement the basic education sub-program; SSA will implement the basic health services sub-program. STPS will implement the labor training sub-program and SEDESOL will implement the short-term employment generation sub-program. SEDESOL, SSA and the DIF will implement the priority food and nutrition program through the state and municipal governments.
- 5.2 Program Readiness for Implementation. In the case of health and education, PROSSE essentially finances ongoing programs and activities, and is thus by definition ready for immediate implementation. In the case of the short-term employment sub-program (PESE), the GOM has defined the operational parameters. In the case of nutrition, one state (Hidalgo) is ready to proceed. The additional states will enter into the program in 1996.
- 5.3 Monitoring Indicators. During appraisal, monitoring indicators for program implementation and initial program impact were discussed and agreed. This will form an important basis for the program implementation reviews. During negotiations, agreement was reached on a satisfactory program monitoring indicators to be established no later than December 31, 1995 and that the system be implemented throughout the remaining life of the PROSSE.

B. Supervision

- 5.4 Supervision would focus on the quarterly review of physical attainment of the sub-programs against the monitoring indicators and the budget release for the PROSSE supported activities. Special attention will be paid to monitoring the effectiveness of

targeting to the poor of the PROSSE supported programs and providing training and technical assistance to procurement staff in agencies with limited experience with the Banks' procurement procedures. The supervision team would be carefully planned and would be a combination of IBRD and IDB staff and consultants who would be recruited according to the critical needs of program implementation. It is estimated that 60 staffweeks will be required for supervision in FY96 and 35 in FY97. This estimate takes into account the multi-sectoral nature of PROSSE, the institutional development aspects, the prior review and procurement arrangements as agreed under PROSSE.

C. Quarterly Reviews

- 5.5 The Banks will monitor compliance with the program through a program of Quarterly Reviews. Each Quarterly Review will be organized by the SHCP, and will include representatives of all the executing agencies and NAFIN. The purpose of the quarterly review meeting would be to evaluate program performance against implementation plans and agreed targets; provide management with feedback on program achievements and areas needing improvement; and further develop programmatic improvements to increase the efficiency of social sector expenditures. A useful tool in this regard will be the physical audits and qualitative assessments undertaken through Sub-Program 5 (paras. 3.23-3.24). The reviews and planning process will provide a tool for on-going refinements in program strategies and plans, consistent with the overall objectives of the program. During negotiations, GOM confirmed it would undertake Quarterly Reviews on the budgetary releases and physical implementation progress of PROSSE with the Banks .
- 5.6 The first Quarterly Review will be held in July 1995 and will focus on program effectiveness and accelerating initial disbursements. The October 1995 mission will focus on the budget allocations for programs supported by PROSSE in 1996. During negotiations, GOM confirmed that it will reach agreement with the Banks on the budgetary allocations for the programs to be supported by PROSSE in 1996 no later than October 30, 1995, taking into consideration the physical performance of such programs during 1995, and that no changes would be made in the allocations for such programs without prior consultation with the Banks. No more than 60% of program resources will be committed until a satisfactory 1996 budget is approved. In the event of a reduction in the fiscal budget (with corresponding reductions in spending in absolute terms), the Banks would review the appropriateness of expenditure allocations and, if necessary, work with the GOM to reformulate plans for new physical investments under the PROSSE programs.

- 5.7 The January 1996 mission will focus on the achievement against indicators for 1995 and confirm actual budget allocations for 1996. The April 1996 mission will focus on reviewing progress in establishing the new social sector monitoring and budget impact system in the SHCP Politica Presupuestal and how this system could be utilized in the 1997 budget allocations. The July 1996 review will focus on the 1997 budget allocations and possible follow up time-slice operations such as the PROSSE. The October 1996 review will focus on an assessment of accomplishments under PROSSE, the 1997 budget, and include the appraisal of any follow-on program support.

VI. PROGRAM BENEFITS AND RISKS

A. Program Benefits

- 6.1 The program would help reduce possible increases in poverty brought about by the economic recession, through preserving essential social services for the poor, providing training and employment enhancement opportunities for 800,000 unemployed and underemployed workers over the two year period through PROBECAT (350,000 in 1995 and 450,000 in 1996), plus 550,000 short-term jobs for the unemployed poor through the SEDESOL program, providing enhanced food and nutrition supplements to women and children in priority areas. Indigenous populations will benefit in particular from the services provided under the basic education, health and nutrition sub-programs as these programs are targeted to the poorest areas where the indigenous populations are concentrated. The primary benefit of the PROSSE for the selected services and programs is that it commits SHCP and the executing agencies to support priority programs targeted to the poor.
- 6.2 Program Objective and Poverty Category: The PROSSE forms a central part of the targeted interventions to Mexico by protecting essential social services to the poor and providing a low-cost social safety net, through short-term employment generation to those adversely affected by the economic crisis and food and nutrition programs to the most vulnerable groups of the population. It thus falls under the Poverty Reduction category. This is a programs of targeted interventions. The essential social services included are focused on the poor in the following manner: CONAFE works only among the poor mainly in isolated rural areas, civil works covered under PROSSE are exclusively in poor rural and peri-urban areas, whilst the SSA services are self-targeting to the poor, as they cover only the population without access to the social security system or without the financial means to go to the private sector. The labor retraining and employment promotion program is self-targeted exclusively to the unemployed and underemployed as they are registered by the state employment services in the case of STPS or self-targeted to the poorest by the payment at only 80 percent of the minimum wage in the case of the short term employment program under SEDESOL. The nutrition program uses nutritional indicators, which have an extremely high correlation with poverty, and the CONAPO poverty index (based upon 10 census indicators of poverty) to identify the beneficiary municipios.
- 6.3 Environmental Aspects. No major environmental issues are foreseen. However, due to the inclusion of the scattered small civil works physical sub-programs under the employment generation sub-program (para. 3.15), PROSSE is rated category B and III for IBRD and IDB,

respectively, for environmental purposes. The environmental impact of sub- programs will follow the criteria and procedures agreed in the IBRD financed Second Decentralization and Regional Development Project (Loan 3790-ME, FY95) and the IDB financed Municipal Development Program (Loan ME-0051, FY 95).

- 6.4 Under the small civil works sub-programs, no significant direct or indirect negative environmental impact is expected from the spot construction and maintenance actions. Final engineering designs are prepared on the basis of agreed technical guidelines for the spot improvement program, which include actions to alleviate, reverse, or offset direct environmental impacts, in particular those related to erosion and siltation. By their very nature, spot improvements and routine maintenance focus on identification, diagnosis and elimination of erosion problems. Since the selected roads are existing ones and among the oldest in the rural road network, additional indirect negative impacts linked with human activities are almost nonexistent.
- 6.5 Participatory Approach: A number of elements of PROSSE involve strong community participation, namely: (i) under the education sub-program, the community provides food and accommodation for the CONAFE community teachers in rural areas, whilst indigenous populations participate in the development and design of textbooks for indigenous education; (ii) under the health sub-program, community participation is mobilized during the health campaigns; (iii) under the employment sub-program, communities form committees and make proposals to the municipio for small infrastructure projects to be managed by themselves (with technical support from the states and municipios) thus following the approach already well tested under PRONASOL; and (iv) the priority nutrition sub-program involves close community participation in: health and school activities; food distribution logistics; and development of priority projects selected by the community (i.e. sanitation, housing, improvements to community health posts and schools).

B. Economic Benefits

- 6.6 Whilst it is not possible to undertake an economic evaluation of the PROSSE as a whole, the PROSSE supports the most essential and some of the most cost-effective social sector programs in Mexico. The relevant economic analysis behind some of the programs supported by PROSSE is presented in detail in Annex 3 in the project files.
- 6.7 This analysis may be summarized as follows:
- a. Education: Recent analysis (based upon data for 1992) shows that the average economic social rate of return per additional

year of schooling is 11.8 percent for primary education and 14.7 percent for lower secondary (the highest rate of return for all levels of education studied) - it is lowest for tertiary education. The fact that lower secondary education shows a higher rate of return at the margin reflects the near universality of primary education in Mexico (and hence diminishing rates of return to primary education). This establishes a clear case for expanding lower secondary education although telesecundaria in rural areas. Unfortunately this analysis did not include analysis of rates of return for pre-school education, although recent analysis, based upon the US experience shows high rates of return to pre-school education.

- b. Health: Analysis undertaken by the SSA, with IBRD assistance, in 1994 measured cost per disability-adjusted life-year (DALY) saved as a result of over 100 health interventions. The most cost-effective interventions (with cost per DALY of less are all included in the basic package of services provided by the SSA under PROSSE. They range from N\$58 per DALY for attention to sick children for treatment of acute diarrhea in children, N\$182 for treatment of leprosy, through to diagnosis of cervical-uterine cancer N\$1,287, health education N\$2,000, treatment of asthma at N\$2,772 and treatment of burns at N\$2,984. At the opposite extreme treatments and prevention not in the package supported under PROSSE include: osteoporosis prevention N\$7,500, by-pass surgery N\$10,985, and multiple sclerosis treatment at N\$37,157.
- c. Labor Retraining: Based upon a cost benefit analysis completed April 19, 1995, PROBECAT had a positive impact for 10 out of 12 categories of trainees evaluated, representing 95.5% of all trainees. Particularly, encouraging was the positive impact upon women (this is in contract to the earlier analysis as reported in the SAR for the Labor Market & Productivity Enhancement project (Loan 3542-ME). Once again, the analysis clearly demonstrates the enhanced effectiveness of in-plant training (one modality of on-the-job training) over class-room based training for those without prior work experience. This also provides a basis for shifting a significant proportion of trainees to the on-the-job training modality.

C. Program Risks

- 6.8 The PROSSE is subject to four potential risks: (a) the uncertainty regarding budgetary allocations; (b) program diversity; (c) that PROSSE programs fail in their targeting and efficiency gains; and (d) failure to disburse adequately as a result of inexperience of some implementation agencies with the two Banks' procurement procedures.

- 6.9 Dealing with the first risk is essential to the approach of the PROSSE. Mexico continues to face a high degree of uncertainty in terms of the macroeconomic variables which determine the budgetary ceilings. Maintaining the February 1995 budgetary allocations in real terms for the high priority social service programs under the PROSSE has been included as a key commitment in the Government's policy statement. The Banks will do their best to monitor budgetary releases carefully during implementation. Should further unexpected cuts be necessary, then the program size and targets would need to be revised.
- 6.10 The second risk, program diversity, is being mitigated by concentrating upon a smaller number of agencies which already have experience with IBRD and IDB procedures. Cofinancing by the IDB has also facilitated simplification, as IDB will finance the whole community development sub-program with SEDESOL, where their procedures are well adapted to the realities of a highly decentralized program.
- 6.11 The third risk, that the PROSSE programs are mis-targeted and fail to make efficiency gains is important. All of the PROSSE supported programs are targeted to the poor to varying degrees (see para. 6.2), however there are leakages with even the best targeted programs. Targeting effectiveness will be monitored carefully during supervision (para. 5.4) and through the physical auditing arrangements (para. 5.5). Increasing the efficiency of the programs supported by PROSSE, along with other social sector programs, will need to be worked out over the medium-term. PROSSE itself, through sub-program 5 "Monitoring and Evaluation" will lay the foundation and develop methodologies to measure and incentives to increase efficiency.
- 6.12 Within the fourth risk, a potential problem that could impede disbursements is the inexperience of agencies such as CONALITEG, DIF, some health directorates and state health secretariats in Banks' procurement procedures. To minimize this risk, training of procurement staff in these agencies will be organized as part of the Banks' supervision programs, and technical assistance will be provided by staff at the Banks' Resident Missions.

VII. AGREEMENTS REACHED AND RECOMMENDATION

7.1 During negotiations, agreement was confirmed on:

- a. a letter of policy intent on budgetary policy in the social sectors, including mechanisms to protect budgetary allocations to the social sectors during the financial crisis and measures to increase efficiency ; and
- b. the agency responsible for the execution of the PESE, namely SEDESOL, and on the operational modalities of the PESE.

7.2 During negotiations, agreement was confirmed on the following, that:

- a. the GOM would release budgetary amounts in a timely manner to the executing agencies under PROSSE in 1995 in accordance with the agreed 1995 budget allocations and physical targets included in Annex 2 of the project files and that the GOM may substitute an alternative budget, satisfactory to the Banks, for the PROSSE prior to June 30, 1995 (if such budget is acceptable to the Bank)(para. 2. 8);
- b. the GOM would review the results of the CONALITEG productivity study and agree on an appropriate action plan with the Banks by December 31, 1995 (para. 3.5);
- c. the Government would: (a) provide adequate annual budget allocations and (b) these allocations would be reviewed with the Banks during the Quarterly Reviews (para. 4.3);
- d. SHCP, NAFIN, SEP, SSA, SEDESOL and STPS would: (i) have the records and accounts for each fiscal year audited by independent and qualified auditors with a separate opinion provided on SOEs, in accordance with generally accepted auditing standards and procedures, and with the specific current understanding with the Mexican authorities; (ii) furnish to the Banks, no later than six months after the end of each year, a certified copy of the agreed audit reports; (iii) furnish to the Banks such other information concerning the records and accounts as well as the audit as the Banks would from time to time reasonably request (para. 4.19);
- e. the GOM would establish a satisfactory system of social sector expenditure monitoring indicators no later than June 30, 1995 and that the system be implemented throughout the remaining life of the PROSSE (para. 5.3);

- f. the GOM would undertake the Quarterly Reviews of the budgetary releases and physical implementation progress of PROSSE with the Banks (para. 5.5);
- g. the GOM would confirm that it will reach agreement with the Banks on the budgetary allocations for the programs to be supported by PROSSE in 1996 no later than November 31, 1995, taking into consideration the physical performance of such programs during 1995, that these budgets would be confirmed in final form no later than February 28, 1996 and that no changes would be made in the allocations for such programs without prior consultation with the Banks (para. 5.6); and

7.3 Recommendation. Subject to compliance to the above conditions, the proposed program is suitable for: (a) a IBRD loan of US\$500.0 million equivalent to NAFIN, with the guarantee of the United Mexican States, for 15 years, including a 5-year grace period at the IBRD's standard variable interest rate; and (b) an Inter-American Development Bank loan of US\$500.0 million equivalent to NAFIN with the guarantee of the United Mexican States, for 20 years, including a 4 year grace period at the IDB's standard variable interest rate, including an inspection fee of 1 percent of the loan amount.

APENDICE

PROPOSED RESOLUTION

MEXICO. LOAN ___/OC-ME TO THE NACIONAL FINANCIERA, S.N.C.
(Program of Essential Social Services)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Nacional Financiera, S.N.C., as Borrower, and the Estados Unidos Mexicanos, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of the Program of Essential Social Services. Such financing will be for the amount of up to US\$500,000,000 or its equivalent in other currencies, except that of México, which are part of the Ordinary Capital resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.

Secretariat of Finance and Public Credit
United Mexican States

May 17, 1995, Mexico City

Mr. Enrique Iglesias
President
Inter-American Development Bank
Washington, D.C.

The Mexican Government has adopted a series of fiscal measures to deal with the changes in the macroeconomic situation that are anticipated for 1995. The aim is to bring down inflation in the medium term, restore stability in the foreign exchange and financial markets, and correct the current account imbalance in order to resume the country's economic development and growth on a more solid footing.

The recent adjustment measures announced in March, in the framework of the action program in support of the agreement to overcome the economic emergency, will make it possible to generate a primary surplus of 4.4 percent of GDP, 2.2 percentage points higher than the figure envisaged in the original program placed before Congress in December 1994. This effort will in turn generate an economic surplus of 0.48 percent of GDP, offsetting the increase in finance charges on the public debt. It will also substantially alleviate pressures on the domestic capital market, which will contribute to lower interest rates and thus foster the recovery of investment and growth in productive activities in the country's private and social sectors.

Detailed below are the principal avenues of action undertaken in connection with revenues, spending and, in particular, protection for the more vulnerable segments of society.

Government revenues

To boost public revenues, the Federal Government has authorized higher public-sector tariffs and prices and Congress has approved an increase in the rate of value-added tax (VAT) from 10 to 15 percent, effective in April 1995. Amendments to VAT legislation mean that all stages of production are now taxed at the general rate, except for processed foods and medicines sold directly to the final consumer.

To attenuate the impact of the aforesaid measures and thus protect lower-income workers, a three percent bonus was authorized for those earning the equivalent of two incomes at minimum wage, declining on a straight-line basis to zero at the equivalent of four incomes at minimum wage. This bonus is being granted in addition to the three percent extended last January to workers earning up to the equivalent of two incomes at minimum wage.

To stimulate private investment in 1995, the eligible tax deduction was raised for companies under the immediate deduction option, for this year only.

It is important to note that these revenue measures will also translate into more robust state and municipal finances, since higher taxes and higher prices for gasoline and diesel will generate more funds for revenue-sharing. This in turn will improve the Government's financial position and will enable it to continue to pursue action to foster social well-being.

Public spending

Since public spending was one of the main instruments of economic policy used in stabilization and is one of the most effective tools for fostering social development, public outlays under the action program mentioned earlier will be employed to meet the following objectives:

1. Reduce the public sector's financing needs by cutting spending to alleviate pressures on the capital market, bringing down interest rates and thereby contributing to rapid economic recovery, in the recognition that sustained growth can only be built upon macroeconomic stability; and
2. Improve efficiency in the management of public funds, particularly funds used to protect those most in need, in order to achieve the goals and objectives set.

The stabilization objectives will be achieved through a 9.8 percent real reduction in spending programmed for 1995 as compared to the year-end estimate for 1994. Accordingly, outlays in respect of current expenditure and capital expenditure by the Federal Government and its agencies and parastatal enterprises will equal 18.2 percent of projected GDP for 1995; that is, 1.52 percentage points less than in 1994 and 1.62 percentage points less than the amount approved by the Chamber of Representatives for 1995.

These adjustments in public spending have been made while safeguarding and even intensifying the major goals of social development and the development of rural areas. In addition, to bring in more short- and medium-term resources and to stimulate productive activity, budget appropriations have been maintained for investment projects, particularly those which generate foreign exchange or have an impact on goods and services used in large amounts by domestic industry.

Since personal services accounted for 41 percent of programmable spending by the public sector, several steps have been undertaken to lower their cost by 9 percent in real terms from the 1994 figure. Moreover, a 12.3 percent real cut will be applied to current spending on items other than personal services, materials and supplies, and general services.

The specific actions being taken to lower the cost of personal services are as follows:

- Downsizing of the central public administration through a detailed review of positions and duties, eliminating low-priority programs, avoiding overlapping duties, and generating immediate and long-term budgetary savings;
- Freeze on existing vacancies for core positions and cancellation of vacancies for positions of trust;
- Suspension of hiring for new positions in sectors other than education and health and the armed forces, which are to be covered with savings on positions within the central public administration itself;
- Assessment of offices representing the federal government abroad, to keep only those essential to fulfilling the objectives set; and
- Implementation of a special voluntary retirement program, in conjunction with training for those employees who wish to take advantage of it.

For current spending items other than personal services, the following measures have been undertaken:

- Cuts in public-sector procurement programs to promote a more intensive and efficient use of inventories;
- Rationalization of physical space at public-sector agencies and organizations, leading to physical integration of administrative units, lower payments for rent and associated expenses including cleaning and security, and lower payments for basic services such as electricity, water and telephone;
- Review of the subsidy policy that channels fiscal resources mainly to organizations in the social development and rural development sectors; and
- Standardization and streamlining of criteria for beneficiaries of directed subsidies programs, to make such programs more efficient and more effective and thus protect needy groups, the production of goods, and the provision of services.

Measures relating to investment spending are as follows:

- Deferred commencement of new projects at agencies of the federal public administration and slower execution for projects now under way;
- Priority attention to infrastructure conservation and maintenance, and to environmental protection projects; and

- In decentralizing public spending, the transfer of programs in which direct participation by state and municipal levels of government will eliminate duplication and make for a more effective use of public funds.

Social spending

Given the applications of fiscal resources, programmable federal spending is one of the economic policy instruments that can be used to promote social development. In this sense, public funds for the social sectors, i.e. for education, health care, pensions, employment, urban development, environmental protection and potable water, as well as programs in support of low-income groups, are allocated to improve the well-being of the population.

The composition of public spending has been altered in recent years as a result of economic reforms and the restructuring of public finances. The privatization of parastatal enterprises enabled the public sector to free up resources formerly used for subsidies. The proceeds of the sale of these enterprises were used to pay down the public debt. The application of fiscal discipline brought significantly lower domestic finance charges. Thanks to these measures, considerable headway was made in redirecting public spending toward social programs. As a result of such efforts, social spending accounted for a rising share of total programmable spending, from 38.1 percent in 1990 to 52.6 percent in 1994 to over 55 percent in 1995.

Throughout the fiscal adjustment process, a major effort has been made to preserve the budget for activities that represent fundamental components of the strategy to improve family well-being and combat poverty. This will in turn improve the coverage and scope of educational and health care services.

In connection with educational spending, it should be noted that in building new educational facilities, preference will be given to the preschool and secondary levels, programs to overcome lags in the country's more remote regions, and the number of scholarships for outstanding low-income students at the primary and secondary levels.

The strategy to preserve social spending calls for close coordination among public health institutions to augment the goals set for universal vaccination programs in 1995. Coverage will also be expanded for curative care programs, outpatient service visits, and hospitalization, in order to provide care to a larger population, with special emphasis on those living in marginal urban and rural communities.

Coverage was extended in 1995 from two to six months for illness and maternity insurance provided by the Mexican Social Security Institute to employees temporarily displaced from their jobs.

With respect to job training, and to attenuate the social impact of the current economic situation, budget resources allocated for traineeships for the unemployed and support for active employees have risen to fund 700,000 under the job traineeship program and the total quality and modernization program. This represents 200,000 more than originally budgeted and represents an effective investment in our most valuable economic resource. It will also lay the groundwork for raising real wages in the medium term, based on productivity.

In the rural sector, the Social Development Secretariat will coordinate a new rural employment program to promote the construction of roads and rural infrastructure. In this way, the more disadvantaged groups within this sector will be able to rely on a minimum income.

Also, in order to protect the incomes of agricultural producers, the payment per hectare under the rural direct support program (PROCAMPO) was increased. Support for the fall-winter season was raised from N\$380 to N\$400 per hectare, and the payment for the spring-summer season will rise from N\$400 to N\$440.

A comprehensive review has been undertaken of consumer subsidies, both directed and general. Where applicable, they will be replaced by a simpler, more transparent and more effective model of income support for those workers now living in marginal conditions and poverty. In this way, society's fiscal efforts will provide support to those most in need of it, eliminating excessive administrative expenses and duplication of effort and improving subsidy allocation. During the transition to this new model, support already being provided will be strengthened.

To centralize actions to supply food to low-income groups, an administrative reform was undertaken to bring all such programs under the aegis of the Social Development Secretariat. This will improve the effectiveness and social impact of the Tortilla Solidaridad, LICONSA and DICONSA programs. The objectives of those programs are to distribute one kilogram of tortillas daily, free of charge, to 2.3 million families with incomes less than the equivalent of two incomes at minimum wage; to distribute half a liter of milk daily to 6.5 million children under the age of 12; and to supply basic foodstuffs to a population of 30 million low-income individuals through 1,725 points of sale in marginal urban areas and 19,479 in rural areas.

In addition, the National Institute of Indigenous Development will provide 1,111 school shelters with nutritional support, medical service and dormitories for 58,000 indigenous students, as well as 8,000 scholarships for intermediate education.

Evaluation of social programs

One of the main objectives of public spending policy is to render the use of budgetary resources more effective to bring better results on

social programs in terms of both quality and efficiency. As a result, given the vast needs of the population on the one hand, and the existing constraints on growth in fiscal revenues on the other, it is essential that progress be made on the studies and work needed to achieve those objectives. The Secretariat of Finance and Public Credit therefore intends to carry out preliminary work for measuring the results of social programs, thus furnishing elements in addition to those called for under financial audits and requirements for the preparation and presentation of the Federal Public Treasury Account.

The purpose of the work to begin monitoring and auditing the results of social programs is also to identify efficiency indicators for determining the cost-effectiveness of the programs and to optimize budget allocation in the 1997 fiscal year.

In order to obtain the best possible social returns, the studies evaluating results will give priority to programs delivering health care, training, and subsidies for consumption and nutrition for the low-income population.

In the context of the objectives set forth in the National Development Plan for the 1995-2000 period, the Mexican Government will preserve spending on programs for social services or other programs equivalent to those envisaged in the Program of Essential Social Services and the Draft Budget of Federal Expenditures for the 1996 fiscal year, using the resource levels allocated to those programs in the 1995 budget by way of a reference.

Please accept the assurances of my highest consideration.

[signed]

Guillermo Ortiz
Secretary