

PROFILE I

MEXICO

AUGUST 13, 2002

Project name:	Health and Social Security Reform for Government Workers			
Project number:	ME-0245			
Project team:	Mark Homonoff, (RE2/SO2), Team Leader; Juan Carlos de la Hoz, (RE2/SO2); Kurt Focke, (RE2/FI2); Consuelo Ricart, (RE2/SO2); Javier Jiménez, (LEG/OPR); and Francisco Bustamante (COF/CME).			
Borrower:	Government of Mexico			
Executing agency:	Secretaría de Hacienda y Crédito Público (SHCP) and Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (ISSSTE)			
Financing plan:		Tranche I	Tranche II	Total
	IDB Loan (OC):	US\$140 m.	US\$135 m.	US\$ 275 m.
	Technical Cooperation Loan		US\$ 5 m.	US\$ 5 m.
Tentative dates:	Next Mission:	August 2002		
	Loan Committee:	October 2002		
	Board:	February 2003		

I. BACKGROUND

A. ISSSTE and the Need for Reform

- 1.1 The Social Security Institute for Governmental Workers in Mexico employs approximately 90,000 workers and provides benefits for 10 million persons of whom 2 million workers are contributors. The median income for these middle class workers of the Institute is in the sixth decile of Mexican family incomes, with a mode in the fourth decile. The Institute comprises three major funds in health, pension, and housing with additional lines of business that serve the interests of its beneficiaries¹. The organization faces a crisis in two major lines of

¹ The nine core activities are as follows: Fondo de Pensiones, encompassing a range of products that includes retirement accounts, disability insurance, and special death benefits; Fondo Médico; Fondo de Préstamos Personales; Fondo de Prestaciones Sociales y Culturales; Fondo de Riesgos de Trabajo;

operation, the health fund and pension fund, and is in urgent need of reform to assure financial stabilization. The actuarial base of these funds has changed drastically over the past twenty years. In health, total beneficiaries of its services have risen from 490,000 in 1980 to the current number of 10 million. In the area of pensions, there are now five active workers for each retiree, compared to 20 in 1980, with the expected life beyond retirement age increasing from 2.5 years to 19 years in the same period. The number of retirees, approximately 400,000 at this time, has increased by 450% over twenty years. These factors have placed enormous stress on the operations and financial performance of ISSSTE.

- 1.2 The health fund is seeking a resolution to a trend of accelerating deficits. ISSSTE is the third largest institutional health provider in Mexico, following IMSS (Instituto Mexicano del Seguro Social, the private social security institute, with a beneficiary population of 40 million members of the middle class), and the Secretaría de Salud (with a population of 15 million beneficiaries from rural and urban poverty groups). The health fund has been in a state of deficit since 1997 and calculated its 2001 losses as 10.3% of expenditures over collections (or \$100 Million). Projected accumulated deficits for the period of 2002 through 2006 are for an additional \$800 Million even given minimal investment in plant and equipment. Despite what appears to be over-capacity of facilities in some geographical regions, the organization must purchase services in others due to the inflexibility of its mechanism for planning. Much of the infrastructure is too old for effective use, and finances are strapped for the purchase of new equipment and development of modern facilities. These problems have led to negative public estimation of the quality of care, and the trend of members to purchase additional services out-of-pocket.
- 1.3 The pension fund cannot meet financial obligations through its members' contributions and faces an increasing annual deficit that has ascended to 60% of total pension expense (or \$1.2 billion dollars). Emergency funding provided by the legislature, for \$1 billion dollars in 2001, has had no lasting effect on a system that is actuarially and structurally flawed. The system promises to be a continuing drain on public finances. The average age of the retiree has changed from 62 years in 1980 to 55 years in 2000. This is due to statutory changes promoting the reduction of retirement age, and the encouragement of a policy of early retirement. Strikingly, the fund has no reserves of any kind, and functions at the level of "pay as you go", in which part or all of the income received from active members is paid out to the retirees for defined benefits.
- 1.4 At the current level of expenditures, the situation at ISSSTE has a meaningful fiscal impact. Given predicted levels of government deficit for 2002, and currently projected pension deficits, the system's losses are expected to accelerate to those 15 billion pesos, or 2% of public sector deficit for 2002, and twice that amount in actual deficit (26 billion pesos) in 2006.

- 1.5 The implementation of a reform in health will involve substantial costs before results can be seen, and on pension side, changes to a capitalized system from “pay as you go” will imply transitional fiscal costs. The current fiscal deficit is significant, and its long-term potential impact on the macroeconomic situation is dire, arguing for an organized reform that will reduce deficits and their consequences with support through sectoral lending

B. Context of Pension and Benefit Fund Reform in Mexico and Experience to date with ISSSTE

- 1.6 The plans for the reform of ISSSTE build on experiences acquired by the Bank and World Bank in pension reform in Mexico. In the late 1990’s, the IDB funded a project, “Contractual Savings Development Program” in Mexico (ME-0197; \$300 Million), along with the World Bank, for a structural reform of IMSS. The World Bank program was for \$1.5 billion of which \$700 million was made available for health. The project was successful in taking those initial steps necessary to establish a viable pension system, which included, among others, a system of individual retirement account management (AFOREs) within the banking system, along with a fundamental change in the pension structure from one of defined benefit to defined contribution for new entrants in the system. To this project with ISSSTE, IDB also brings the experience that it has gleaned in pension system reform programs that include Nicaragua, and in health reform programs throughout Central America and South America, encompassing Honduras, Panama, and Brazil.
- 1.7 Additional experience in Mexico contributes to the Bank’s participation in this program. Previous policy based loans in Mexico have been developed for the financial sector, most recently in the “Program to Support the Restructuring of the Banking System (ME-0227)”, and in financial and institutional reform for states and municipalities in “States and Municipalities Strengthening Program (ME-0208)”, which is a hybrid of fast disbursing and investment funds. The IDB has been working with ISSSTE from the outset of its health reform in discussions to assist in setting out the broad outlines for the program. The IDB has brought in addition to its technical expertise in health, an area in which its efforts with ISSSTE have focused to date, familiarity with the role of facilitator in technical and policy dialogues throughout Mexico.
- 1.8 The proposed Bank operation will draw in particular on lessons learned from the IMSS reform experience. The recent reform of IMSS may offer a model in terms of enhancing the use of individual retirement accounts through the private banking system. The new model will include two “pillars.”² The older employees will continue under a revamped defined benefit plan, in which contributions will guarantee a predictable pay-out, and the newer employees will face a plan that works on a capitalization system with a guaranteed minimum payout. For those

² “Pillars” refer to subcomponents of the pension program that have their own financing and obligations to pay beneficiaries. They are complementary and build upon each other.

persons moving from the government sector to self-employed or private sector, benefits will be structured so that retirement funds will travel with them (“portability”). However questions remain as to which is the best mechanism for raising capital contributions. It is unlikely that the government will be able to shift the financial shortfalls in the pension segment to the burden of public obligation. Nor can it rely principally on the entry of new workers in the system to support the benefits of current workers given a static membership population. In health, it must depend on cost savings to be gained by shifting the care away from fixed hospital facilities, and attention paid to the separation of provision and financing of services. General plans for the reform of ISSSTE have been under consideration for several years. The new Administration appreciates the severity of the situation and sees the need for making necessary changes in what could otherwise become a scenario of financial meltdown

C. IDB and World Bank Collaboration

- 1.9 The IDB and the World Bank have agreed to collaborate in the preparation of this program. The lending program will address health and pension segments as well as corporate reorganization through a single conditionality matrix and a parallel program of technical assistance. The reimbursable technical assistance program will be designed to promote the implementation of policy conditions. The World Bank plans three policy-based loans through 2004 with a total of \$700 Million allocated.
- 1.10 Resources for the preparation of the lending program will come from a non-reimbursable technical cooperation from the Japanese Special Fund for “Corporate Reorganization of ISSSTE” (TC-01-10-008 for \$750,000). This technical cooperation has been prepared and is currently awaiting approval from the donor. The World Bank has provided funds to date for studies in the areas of pensions and health, for approximately \$150,000, from another non-reimbursable technical cooperation from JSF that is under the administration of IMSS. Consultant programs under TC-01-10-008 are being prepared conjointly in the spirit of the collaborative venture.

D. Bank’s Strategy and Rationale for Participation

- 1.11 This operation is consistent with Mexican government’s strategy for health and social benefits improvements as outlined in the “Plan Nacional de Desarrollo, 2001-2006”. On the side of health, the program is consistent with goals of raising the level of care and setting of uniform standards of health care for all institutions in Mexico. This project will set goals of improvement of quality in care and enhance programs for preventive health within ISSSTE. On the side of pensions, the program would help further the strategy’s objectives of focusing on needs of the aged by assuring predictable long-term benefits for workers of the state. The pursuit of this program is also consistent with IDB’s Country Paper recommendations, approved in January of 2002. These objectives center around the modernization of the social sector and will be met through this program by

improvements made in the capacity of health care institutions to develop new approaches at the family care and specialized care levels, and by providing a social safety net for persons facing financial vulnerability in their advanced years.

- 1.12 The proposed operation would assist the Government of Mexico in inaugurating a structural reform of the government employees' benefit fund, ISSSTE. While in the short-term, the program of stabilization will have a negative fiscal effect because of the high transition costs for change from the current system to a new model, the long-term gains from stabilization of this system warrant taking up this reform as soon as possible. Reform of the pension system could provide new opportunities to a burgeoning domestic insurance industry, and infuse further stable cash reserves in the banking system through their enhanced involvement in pension, workers' compensation, and disability programs. On the side of health, new opportunities may be given to private sector participants in all areas, including physician groups, hospitals, purchasing plans, and actuarial organizations.

II. OBJECTIVES AND DESCRIPTION

A. Objectives

- 2.1 The objective of the program is to support the Government of Mexico in the reform of ISSSTE by assuring the continuity of benefits in health and pensions through a program of cost savings and financial stabilization. The program will provide assistance to the government in meeting the objectives of stemming the deficit and improving quality of care in health, re-design of the pension system to allow for financial sustainability, and reorganization of central administrative functions to improve effective resources planning.

B. Description

- 2.2 The proposed operation will be structured as a sector loan for a total of US\$275 million and will comprise two tranches. The first tranche will be \$140 million, with a second tranche of \$135 million. The conditions of the first tranche will call for the establishment of a legislative framework and an initial accord for a plan of action. A first sectoral loan from the World Bank, for approximately \$250 million, will rely on the same conditions. Conditions for disbursement of the second tranche will specify those terms that are essential for moving the institution along a path of cost savings in health and sustainability in pensions. The Bank's conditionality for disbursement of the second tranche will be identical to the terms for disbursement of a second loan from the World Bank. A performance-based technical cooperation loan of \$5 million will be disbursed with the second tranche of the sector loan on the basis of achievements of specified outputs.
- 2.3 The program will consist of three components, each promoting basic reform activities that will lead to cost savings. The components are as follows: (i)

Improvements in the Health Fund; (ii) Re-establishment of financial solvency in the pension fund; and (iii) Firm-wide corporate reorganization. Discussions are now underway between the SHCP and ISSSTE regarding the details of legislative changes that must be put in place before a comprehensive reform is initiated. Conditions for disbursement of the first tranche will require approval of legislation to reform the health and pension funds with special attention to areas that include the separation of provision of services from financing, new structure for employee contributions, and benefits for the new generation of employees.

1. Component 1. Improvements in the Health Fund

- 2.4 The first component will promote reforms to (i) Enhance participation by the private sector as a provider of services; (ii) Advance the process of outsourcing of services such as warehousing, laundry, and maintenance; (iii) Improve quality of service by providers, for example, through the use of protocols, training, and continuing medical education. Reforms that will arise in the second tranche will include, as follows: (i) Separation of provision and financing of services (provision may involve private sector participation and financing will remain in the public domain); (ii) Complete revamping of medical and administrative payroll to re-deploy human resources according to demand; (iii) New actuarial, accounting, and financial frameworks to keep track of costs of the revitalized system. Policy changes in the health fund should bring about a more flexible structure that can ultimately induce cost savings given new demands placed on the system by an aging population.

2. Component 2. Re-establishment of financial solvency in the Pension Fund

- 2.5 The second component will promote the following reforms: (i) A new framework that addresses two tiers of membership, the old members and a new generation; (ii) Establishment of individual retirement accounts; and (iii) Assurance of financial sustainability of the new program by changes in scope of the benefits and alteration of contributions. Reforms that arise in the second tranche will promote: (i) Effective transfer of beneficiaries to the new plans; (ii) Placement of effective supervision for capitalization of a new system; and (iii) Long-term financing mechanisms for assurance of fiscal sustainability. Policy reform in the pension area will encourage those changes that will become even more essential as the size of the retiree pool enlarges over the next decade.

3. Component 3. Corporate Reorganization

- 2.6 The third component will promote the following reforms: (i) Streamlining of all service activities in an effort to preserve the financial stability of essential services; (ii) Overhaul of human resources and accounting practices; and (iii) Re-definition of hierarchic relations and phasing in of a new system of management incentives to foster financial accountability of individual departments. Reforms that arise in the second tranche will promote: (i) Improved financial performance

for each business line; (ii) New relations between the central administration and the regions that promote fiscal autonomy and management accountability; and (iii) Coordinated human resources policies and accounting practices throughout the Institution. Given the current financial stresses on the organization, policy changes will be directed at long term human resources needs through all operations.

4. Technical Cooperation

- 2.7 A US\$5 million Technical Assistance Loan will address the issues of separation of provision and financing of health, training and redistribution of medical personnel, conversion of the existing pension program to one of multiple tiers of membership, improved financial performance of all business lines, and coordination of human resources and accounting practices throughout the institution. The Plan of Operations for this technical cooperation will be processed along with the loan. The TC will be disbursed once the specified outputs are confirmed. A plan of action with a quarterly review will be designed with standards for compliance. Standard Bank procurement procedures will be used to procure inputs for this Technical Cooperation Loan.

5. Execution

- 2.8 The Secretaría de Hacienda y Crédito Público will be responsible for the overall execution of the program, including the monitoring of the compliance of the proposed conditionalities. ISSSTE will report to SHCP and will be responsible for the implementation of policy reform and for the management of compliance with the proposed technical cooperation loan.

III. SPECIAL ISSUES

- 3.1 The proposed operation will face risks that will include (i) Public acceptance of the program; and (ii) Government commitment to the process of reform. To date, SHCP has demonstrated its commitment to the program. The project, now in design stage, is receiving commentary from SHCP and ISSSTE through all stages of planning. Public acceptance will be assisted by efforts on the part of the Office of the President and the passage of comprehensive legislation in advance of the program. It is felt that the current political environment for change in Mexico provides great advantages for success at this moment in time. The current conditions of financial distress of the pension fund, and the dissatisfaction over performance of the health component of ISSSTE, argue the strong case for reform of the institution without further delay.
- 3.2 The success of the operation will rely on the effective collaboration between the Bank, the World Bank, SHCP, and the institution responsible for implanting the proposed reforms, ISSSTE. The Bank and IBRD have been joint partners in

various operations in the region and have successfully coordinated efforts in housing and financial reforms in Mexico. Currently, there are well established coordination mechanisms in place that allow the two banks to collaborate with Hacienda and ISSSTE in the preparation of this loan. Both banks have assigned project teams that are already coordinating the preparation of technical reports.

IV. STATUS AND PLAN OF ACTION

- 4.1 The proposed operation was entered in the Bank's lending pipeline following a programming mission in October of 2001. In a pre-programming mission in July of 2002, SHCP reiterated that the reform of ISSSTE was a priority of the government. There have been three Bank identification missions designed for information gathering and tied to the development of a non-reimbursable technical assistance program with JSF. This latter technical cooperation, awaiting approval from the donor in July, 2002, will assist in the preparation of the conditionality matrix for the loan. It should also assist in funding the basic ground-work to be done in cost controls firm-wide in advance of the full-scale reform efforts.
- 4.2 If a Profile I were to be approved by the Programming Committee, a joint orientation mission is planned with the World Bank in August of 2002 to define the policy matrix for the project. Tentative dates for processing of the proposed operation are as follows:

Programming Committee: July 2002
Loan Committee: October 2002
Board of Directors: February 2003

Approved by: _____
Jairo Sánchez, RE2/RE2

Date: _____