PROJECT PAPER
ON A
PROPOSED ADDITIONAL FINANCING (LOAN)
IN THE AMOUNT OF
US$30.0 MILLION
TO THE
STATE OF PERNAMBUCO
WITH THE GUARANTEE OF THE
FEDERATIVE REPUBLIC OF BRAZIL
FOR THE
PERNAMBUCO RURAL POVERTY REDUCTION PROJECT

September 11, 2006

Environmentally and Socially Sustainable Development Department
Brazil Country Management Unit
Latin America and the Caribbean Region

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CURRENCY EQUIVALENTS

(Exchange Rate Effective November 30, 2005)

Currency Unit = Real (R$)
R$1.00 = US$0.4533
US$1.00 = R$2.2062

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

CAS - Country Assistance Strategy
CDD - Community-Driven Development
EMP - Environmental Management Plan
HDI - Human Development Index
IEG - Independent Evaluation Group
IPPF - Indigenous Peoples’ Planning Framework
MIS - Management Information System
O & M - Operation and Maintenance
PPA - State Multi-year Investment Program
RPRP - Rural Poverty Reduction Program
SDSC - Secretaria Estadual de Desenvolvimento Social e Cidadania
    - (State Secretariat of Social Development and Citizenship)
SEPLAN - Secretaria Estadual de Planejamento
    - (State Secretariat of Planning)
STU/UNITEC - State Technical Unit

Vice President: Pamela Cox
Country Director: John Briscoe
Sector Director: Laura Tuck
Task Team Leader: Jorge A. Muñoz
BRAZIL
PERNAMBUCO RURAL POVERTY REDUCTION PROJECT
ADDITIONAL FINANCING

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**PROJECT PAPER DATA SHEET**

Date: September 12, 2006  
Country: Brazil  
Project Name: Pernambuco Rural Poverty Reduction Project  
Project ID: P101879  
Borrower: State of Pernambuco

Team Leader: Jorge A. Muñoz  
Sector Director: Laura Tuck  
Country Director: John Briscoe  
Environmental Category: B

Guarantor: Federative Republic of Brazil  
Responsible agency: UNITEC/ State Secretariat for Social Development and Citizenship

<table>
<thead>
<tr>
<th>Revised estimated disbursements (Bank FY/US$m)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FY</strong></td>
</tr>
<tr>
<td>Annual</td>
</tr>
<tr>
<td>Cumulative</td>
</tr>
</tbody>
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Current closing date: January 31, 2007  
Revised closing date: January 31, 2010

Does the restructured or scaled-up project require any exceptions from Bank policies? [ ] Yes [X] No
Have these been approved by Bank management? [ ] Yes [ ] No
Is approval for any policy exception sought from the Board? [ ] Yes [X] No

Revised project development objectives:

The proposed Additional Financing would support the scaling-up of the Rural Poverty Reduction Project in Pernambuco to (1) improve well-being and incomes of the rural poor through greater access to basic social and economic infrastructure and services and support for productive activities, using proven community-driven development (CDD) techniques; (2) increase the social capital of rural communities and capacity to organize collectively to meet their own needs; (3) enhance local governance by greater citizen participation and transparency in decision-making, through creation and strengthening of community associations and Municipal Councils; and (4) foster closer integration of development policies, programs and projects in rural areas at the local level by assisting the project’s participatory Municipal Councils to extend their role in seeking funding from, setting priorities for and making decisions concerning, the allocation of resources from other programs beyond the Bank-supported project.

Does the scaled-up project trigger any new safeguard policies? No

For Additional Financing

[X] Loan  [ ] Credit  [ ] Grant
For Loans:

| Total Bank financing (US$m.): | 30.00 |
| Proposed terms: Variable Spread Loan (VSL) |

<table>
<thead>
<tr>
<th>Financing Plan (US$m.)</th>
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<tr>
<td><strong>Source</strong></td>
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<td>Borrower</td>
</tr>
<tr>
<td>IBRD</td>
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<tr>
<td>Community Associations</td>
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<td><strong>Total</strong></td>
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I. Introduction

This Project Paper seeks the approval of the Executive Directors to provide an additional loan in an amount of US$30.0 million to the State of Pernambuco, with the Guarantee of the Federative Republic of Brazil, for the Pernambuco Rural Poverty Reduction Project (Ln. 4625-BR).

The proposed additional loan would help finance the costs associated with the scaling-up of activities to enhance the impact of this well-performing project. No major changes are proposed to the design or implementation arrangements of the Ongoing Project. The Additional Financing would continue to support basic small-scale infrastructure investments for the rural poor and foster the closer integration of rural development policies, programs and projects at the local level, by mainstreaming the capacity of the existing project-financed Municipal Councils to seek funding from, set priorities for and make decisions concerning the allocation of resources from other State and Federal programs outside the Bank-supported project.

Partnership arrangements: While the proposed Additional Financing does not envisage specific partnership arrangements with other international financing agencies, it is designed to forge even stronger linkages between the project and a series of State and Federal programs and projects also operating in the rural space in Pernambuco. Partnerships under the Original Project have included the Land-based Poverty Alleviation Project I (Ln. 7037-BR, known as Crédito Fundiário), the Federal Water Management Project II (known as PROAGUA Nacional, slated for Board presentation in 2006), and the Pernambuco Integrated Development: Education Quality Improvement Project. Several State and Federal programs such as Luz para Todos (rural electrification), Construction of Cisterns, Adult Education, Combating Desertification and the National Family Agriculture Program (known as PRONAF) are likely candidates for direct integration, working through the project Municipal Councils. The approach to enhancing local-level integration and broadening partnerships would be similar to that adopted under the Bahia State Integrated Project: Rural Poverty (Ln. 7327-BR), approved by the Board in August 2005, the Ceará Rural Poverty Reduction Project – Additional Financing (Loan 7387-BR) approved by the Board on June 6, 2006, and the Piauí Rural Poverty Reduction Project – Additional Financing (Loan 7399-BR) approved by the Board on July 18, 2006. All investment resources secured from these and other programs would be prioritized, debated and decided upon using the existing community associations and participatory Municipal Councils. In the aggregate, these integration efforts are expected to leverage about US$7 for each US$1 of Additional Financing.

II. Background and Rationale for Additional Financing

Original Project Design: The Original Loan, in the amount of US$30.1 million, became effective on January 25, 2002. Objectives under the Original Project are four-fold: (1) improving well-being and incomes of the rural poor through greater access to basic social and economic infrastructure and services and support for productive activities, using proven community-driven development (CDD) techniques; (2) increasing the social capital of rural communities and capacity to organize collectively to meet their own needs; (3) enhancing local governance by greater citizen participation and transparency in decision-making, through creation and strengthening of community associations and municipal councils; and (4) fostering closer integration of development policies, programs and projects in rural areas at the local level, by assisting the project’s participatory municipal councils to extend their role in seeking funding from, setting priorities for and making decisions concerning the allocation of resources from other programs beyond the Bank-supported project.
As under the Original Project, the Additional Financing will support the following three components:

1) **Community Subprojects** will provide matching grants to community associations to finance their implementation of about 1,100 small-scale socio-economic infrastructure, education, health, culture, productive, environmental and other investments. Under the Additional Financing, community subprojects are expected to be slightly larger than under the Original Project and a larger proportion will encompass productive subprojects, which tend to be of higher cost and benefit a smaller number of families.

2) **Institutional Development** will support (a) technical assistance and training to mobilize and strengthen community associations in their role of identifying, preparing, operating and maintaining subproject investments and (b) training for the project Municipal Councils and technical advice for the State Technical Unit for their expanding roles under the Additional Financing; and

3) **Project Administration, Supervision, Monitoring and Evaluation** will support, *inter alia*, the costs (excluding salaries) of State Technical Unit (STU), the monitoring of project implementation and subsequent impact evaluation.

Supervision ratings for the Ongoing Project have consistently been fully Satisfactory, both for Development Objectives and Implementation Progress. The latest supervision mission in April 2006 showed the Pernambuco project reaching some 340,000 people with 1,800 subproject investments in basic socio-economic and productive infrastructure. The 2004 Brazil Country Assistance Evaluation by IEG gave the Northeast Rural Poverty Reduction Program (RPRP) – of which the Pernambuco project is part – a positive overall assessment for its role in expanding provision of basic socioeconomic infrastructure to the rural poor of the Northeast region, and for its use of project-financed Municipal Councils to strengthen social capital, thus laying the foundation for a wider range of poverty reduction activities. The RPRP was also presented at the 2004 Shanghai Conference as a best practice experience in rural poverty reduction.

**Reasons for Additional Financing:** Consistent with other operations under the RPRP, the Federal Government approved borrowing by the State of Pernambuco and also indicated its willingness to support subsequent financing of a future scaling up, provided project performance was satisfactory. Pernambuco initially borrowed US$30.1 million for the ongoing project. Recent Bank supervision confirms satisfactory performance. Project implementation has accelerated since the Mid-term Review in 2004, and all funds under the ongoing loan are fully committed. The State of Pernambuco therefore wishes to proceed with scaling up in the amount of US$30.0 million authorized by the Federal Government. The Federal Government is prepared to guarantee the Additional Financing up to this US$30.0 million amount. Additional Financing in this amount is the most effective way to respond to the immediate opportunity to enhance development impact. Approximately 375 proposed community investments already evaluated by the State Technical Unit (STU), combined with another 1,200 community proposals already available in the Project's participatory Municipal Councils, are awaiting the availability of this funding for implementation. These pending investments, combined with expected, additional strong community demand for the

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1 The RPRP is a CDD program consisting of a set of individual state-level loans (either under supervision or in processing) totaling US$414 m. to Northeast states. These projects share similar characteristics in terms of design, participatory mechanisms and implementation arrangements.
Project during its implementation, ensure that the Project will be implemented in the planned three year period of the Additional Financing loan.

In strategic terms, this financing would continue the Bank’s assistance to the State of Pernambuco and contribute directly to the State’s ability to achieve its Multi-Year Investment Program (PPA, 2004-2007). Indeed, the State’s PPA explicitly assumes the continuation of Bank support, seeks further improvement in the HDI and prioritizes economically fragile regions and municipalities with lowest HDI. Under the Ongoing Project, the State has been working with the Bank to train the Municipal Councils to assess the availability of resources from other, non-project rural programs on behalf of their member community associations. This is having the effect of strengthening the coordination and effectiveness of those same programs through their exposure to the Councils’ participatory mechanisms for priority-setting, decision-making and targeting. Therefore, scaling up would involve not only the Additional Financing from the Bank but also the resources mobilized from other Federal and State programs, thus increasing the overall impact in the rural Northeast.

As the State and the participatory Municipal Councils have gained experience with the project strategy and methodology, the pace of project execution has accelerated and as mentioned, there is a large number of subproject proposals registered in the processing portfolio of the State Technical Unit and awaiting resources. The State Government has asked the Bank to proceed as expeditiously as possible in processing the scaling up and the Additional Financing instrument is well-suited for this purpose. With the volume of community investment demand already established, the experience and capacity of the State Technical Unit and the State Government’s track record on timely and adequate counterpart funding, no difficulties are anticipated for the State in fully utilizing the Additional Financing within the three year period. The closing date for the Ongoing Project is January 31, 2007 and the closing date for the Additional Financing would be January 31, 2010.

As stated earlier, the Ongoing Project is achieving its Development Objectives, and meeting or exceeding all principal physical targets established at appraisal. The project is in compliance with all key Loan covenants. Regular communications between the Bank’s supervision team and the State Government and State Technical Unit, and with beneficiaries in the field, confirm the strong sense of ownership and priority of this project, and its consistency with and importance to, helping the State achieve its PPA.

Implementation Arrangements for the Additional Financing: All implementation arrangements will continue to be the same as under the Original Project, which have consistently been rated satisfactory on both Development Objectives and Implementation Progress. The Project will continue to be managed by UNITEC, the State Technical Unit (STU) of the State Secretariat for Social Development and Citizenship (SDSC), as delegated by the Pernambuco State Secretariat for Planning. The Operational Manual defined for the ongoing project will continue to govern project operations under the Additional Financing. Community associations will identify, prepare, implement, supervise, operate and maintain their investments, as they have done under the Ongoing Project, contracting directly needed technical assistance from the market, and accessing project-financed training and assistance from the State Technical Unit and through their Municipal Councils. As the core project instrument for targeting project benefits and allocating project resources, the project Municipal Councils will continue to be the critical link to local (municipal) governments and will continue to develop capacity to play an important role in local planning and priority-setting, and in leveraging the benefits from other, non-project poverty programs, for poor communities. The fiduciary requirements and tasks associated with procurement and financial
management are detailed in the project Operational Manual and are satisfactory to the Bank. Audit reports and reviews during supervision missions to the State of Pernambuco confirm the effectiveness of these arrangements and they will therefore continue as is under the Additional Financing.

Consistency with the CAS: The 2004 Brazil Country Assistance Evaluation by IEG gave the Northeast Rural Poverty Reduction Program (RPRP) – of which the project in Pernambuco forms part – a positive overall assessment for its role in expanding provision of basic socioeconomic infrastructure to the Northeast’s rural poor and its use of project-financed municipal councils to strengthen social capital, thereby laying the foundation for a wider range of poverty reduction activities. The FY04-07 Brazil Country Assistance Strategy (CAS) indicates that successive projects under the NE rural poverty program, while continuing to finance needed access to basic socioeconomic infrastructure in the rural space, would focus more tightly on income-generating activities, as well as on integrating CDD components more closely with other government activities in the participating municipalities. The proposed additional financing is consistent with the CAS guidance cited. Using the State’s development strategy as the client-driven framework, impact would be scaled up significantly through these integration activities, and by building synergies with other Federal and State programs, and with other Bank operations.

III. Appraisal of Scaled-up Project Activities

A. Economic and Financial Analyses

Important aspects of project design under the Ongoing Project – which will be maintained under the Additional Financing – help to ensure that subproject investments represent the lowest-cost, best alternative: (a) the demand-driven nature of subproject selection helps ensure that scarce resources flow where they are most needed and that selected subprojects are the best alternatives for the communities in question; (b) the now-established use of standard technical designs (projetos padrão) and cost parameters for the most common types of subprojects demanded ensures that community associations implement the least-cost subproject models while decreasing associated search and information costs; (c) delegation of subproject implementation directly to the community associations has been proven to generate very significant cost savings when compared to similar works executed by public sector agencies. Contracting procedures in the Project Operational Manual permit direct contracting by the associations, requiring for example, that they solicit a minimum of three bids for the subproject.

Ex-post internal rates of return have been estimated for the most common types of productive subprojects which have been implemented. These exceeded on average, 30 percent. Analyses assumed constant benefits over the subproject life cycle. In addition to these positive impacts, benefits tend to be largely concentrated in the beneficiary communities. Sensitivity analysis showed that these subprojects are reasonably robust in relation to decreases in output and prices and increases in production costs.

Benefit-cost ratios are high (greater than 2.0) for the main types of productive investments analyzed. Analysis of these subprojects also suggests that investments are generally financially sustainable. Although beneficiary associations do receive a one-time matching grant, the investments tend to be sustainable because cost recovery through user fees by the average community association is normally adequate to cover both O&M and replacement of the original investments before the end of their useful economic life.
B. Technical Analysis

Technical viability of the proposed project has been demonstrated over a decade of successful CDD activity in Pernambuco. Investment cost estimates, physical contingencies, prices and estimates of inputs and outputs are based on actual historical data under the earlier projects in this State and thus considered reliable. Technical standards of specific subprojects will be ensured through standardized designs (including engineering aspects, technical, financial and economic feasibility, O&M, simple environmental guidelines and cost parameters) covering about 80 percent of subproject types normally demanded by the communities. Field evidence demonstrates that these simple, practical standards have enhanced subproject quality, sustainability and cost-effectiveness. All subprojects will be screened by qualified STU staff, primarily in the eight Regional Offices throughout the project area. Community associations can contract technical assistance (up to 8 percent of subproject value) to assist in subproject design and implementation. Training programs are also being offered to develop associations' capacity to prepare, implement, operate and maintain subprojects, as well as acquaint them with existing environmental regulations at the State and Federal level.

C. Fiduciary Analysis

The financial management system to be used under the proposed Additional Financing is the same as that used under the Ongoing Project in Pernambuco. It complies with OP/BP 10.02 and the new Guidelines for Assessment of Financial Management Arrangements. The Guidelines of Fiduciary Management for Community-Driven Development Projects (CDD Guidelines) are also taken into consideration, where applicable. Based on improvements introduced and results during the implementation of the Original Project, as verified by a Bank Financial Management review in Pernambuco in February 2006, the financial management system and other arrangements for the Original Project in Pernambuco are considered satisfactory. They satisfy the Bank's financial management requirements and the Borrower has the installed capacity to disburse through a report based methodology (FMR) with format adapted to the Ongoing Project and the Bank's financial reporting requirements, and this will be the methodology used during implementation of the Additional Financing.

Procurement responsibilities will be carried out by the STU procurement staff, which have successfully performed these functions under the Ongoing Project and are well-versed in Bank procurement policies and procedures, as verified by a Bank procurement post-review mission in May 2006. As under the Ongoing Project, with the exception of some technical assistance procured by the STU for the community associations and Municipal Councils, it is anticipated that most procurement undertaken with the Additional Financing would be carried out by the beneficiary community associations, following CDD guidelines. The beneficiaries have already demonstrated satisfactory administrative capacity in preparing the subproject proposals; this would continue to be evaluated by the STU at the time of their submission. The STU would also exercise overall quality control of procurement financed by the community subprojects. Staff at the STU will be retained for the implementation of the Additional Financing so as to assure continuity of this good performance.

D. Safeguards

Environment (OP 4.01): The Ongoing Project is a Category B; the same rating will apply to the activities supported by the Additional Financing. Neither the State, nor the Bank, through the
project, will approve subprojects which cause degradation to essential natural habitats. Despite the small scale of individual investments, the STU requires that these subprojects comply with Federal and State environmental laws. As under the Ongoing Project, no subproject agreement will be signed or funds transferred until the environmental viability of the subproject is determined. The subproject agreements eventually signed between the STU and community associations will contain environmental compliance clauses.

An Environmental Management Plan (EMP) prepared by the STU, with input from the principal State environmental agencies, is already in place for the Ongoing Project, has worked well and will guide implementation under the proposed additional financing. The EMP describes the legal, institutional and operational context, as well as the requirements and procedures for ensuring that environmental issues are addressed throughout project implementation. These represent a continuation of procedures already defined in the Project Operational Manual and applied systematically and routinely under the Ongoing Project, with the addition of new developments drawn from lessons learned and activities required under more recent environmental legislation in the State of Pernambuco. The Project Operational Manual also details the procedures for addressing Natural Habitats (OP/BP 4.04), Pest Management (OP 4.09) and Cultural Property (OPN 11.03, being revised as OP 4.11).

Indigenous Peoples (OP 4.10): The Atlas of Indigenous Lands of the Northeast identifies eight ethnic groupings - Atikum, Fuli�-ô, Kambiuvá, Kapinawá, Pankararu, Truká, Tuxa and Xucuru. Estimates by other institutions, including the Indigenous Missionary Council (CIMI) and the Socio-Environmental Institute (ISA), range up to 14 ethnic groupings - adding Pankará, Pankaru, Pipipan, Arara, Kaapor and Tumbalala. Additionally, research from the National Health Foundation (FUNASA) shows indigenous groups living in 180 villages distributed among 13 municipalities, of which seven are among those municipalities in Pernambuco with lowest HDI.

An Indigenous Peoples Planning Framework (IPPF) is also in place for the Ongoing Project to promote the social inclusion of indigenous communities while respecting their cultural identities. Under the Original Project, some 1,700 indigenous people (or some 7% of the total indigenous population) were benefited under subproject investments in housing rehabilitation and rural water systems. The Project, with the Additional Financing, will expand its assistance to indigenous communities through coordinated actions with other governmental and non-governmental agencies also working in the project area.

IV. Expected Outcomes

The proposed Additional Financing will benefit some 170,000 rural poor people (or 38,000 families) in Pernambuco through the implementation of approximately 1,100 small-scale basic socio-economic infrastructure and productive subprojects. The outcome indicators will be similar to those of the Original Project and tracking will be done of (i) the number of rural poor families benefited, through the number of subprojects financed and completed; (ii) improved living conditions and household incomes, using survey-based and other data sources; (iii) non-project funds which are leveraged through the community associations and project-financed Municipal Councils, drawing on Management Information System (MIS) data; and (iv) changes in accumulated social capital of the community associations and Municipal Councils, as measured by the Community Participation Index (CPI).

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V. Benefits and Risks

There are strong indications of positive changes in the quality of life for those households which have benefited under the Northeast Program generally and, specifically, for the proposed additional financing in Pernambuco. From a sample across 130 municipalities in three Northeastern states (including Pernambuco), an assessment was conducted of changes in living conditions among Program beneficiaries from 2000 to 2003. More than 80% of these households indicated that their quality of life had improved as a result of the subproject investment, particularly in the areas of family health, physical living conditions (e.g., housing, sanitation, and durable goods) and nutrition. Mean household incomes also increased. Overall, some 45% of beneficiary families had access to safe water and more than 70% had obtained electricity. Electrical appliance use increased by about 30%, while a majority of households also reported increased housing values. Greater access to safe water led to improved water quality (reported by 55% of respondents), reduced sickness caused by having to search for water and greater physical comfort (73% of respondents) and reduced incidence of water-borne disease (50% of respondents). Some 20% of respondents further reported increased agricultural production as a result of subprojects which financed small dams in their communities (see FECAMP 2004 and Khan 2002 for greater detail).

The scaling up to be supported under the Additional Financing poses no additional risks anticipated, other than those which were identified for the ongoing project and for which mitigation measures have been successfully taken during the course of its implementation. This is a mature but still-evolving program subject to continuous adjustments based on a well-established monitoring and evaluation system.

VI. Financial Terms and Conditions for the Additional Financing

The State of Pernambuco has selected a variable spread Loan (VSL) in U.S. Dollars with a commitment-based amortization consisting of level payments of principal, payment dates on February 15 and August 15, five years of grace period, and 17 years of total loan term. The selection reflects the State’s preference for contracting loans which permit the matching of its asset and liability management objectives.

VII. Allocation of Loan Proceeds

<table>
<thead>
<tr>
<th>Expenditure Category</th>
<th>Project Cost in US$M</th>
<th>Financing Percentage</th>
<th>Allocation of Loan Proceeds (US$M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Grants for Community Subprojects</td>
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</tr>
<tr>
<td>(a) Area 1 Grants</td>
<td>21.81</td>
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<td>(b) Area 2 Grants</td>
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<td>2. Consultants’ services and training for Parts</td>
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<td>3. Administrative Costs</td>
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<td>4. Unallocated</td>
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