Report Number: ICRR0023332

1. Operation Information

Operation ID P164588	**Operation Name** Mato Grosso Fiscal DPL
Country Brazil	**Practice Area (Lead)** Macroeconomics, Trade and Investment

Non-Programmatic DPF

L/C/TF Number(s) IBRD-89660	**Closing Date (Original)** 31-Dec-2021	**Total Financing (USD)** 248,883,034.00
Bank Approval Date 24-May-2019	**Closing Date (Actual)** 31-Dec-2021	

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	250,000,000.00	0.00
Revised Commitment	248,883,034.00	0.00
Actual	248,883,034.00	0.00

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2. Program Objectives and Pillars/Policy Areas

a. Objectives

The Program Development Objective (PDO) of this DPL was “to support the State of Mato Grosso to (i) regain fiscal sustainability and (ii) increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation” (PD, page 3).

b. Pillars/Policy Areas

The operation has two pillars supported by 8 prior actions, as outlined below.

Pillar A: Regaining Fiscal Sustainability

Prior Action 1: The Borrower has enacted legislation that clarifies and tightens personnel spending limits and sets targets for current savings, as evidenced by the adoption and publication of the Borrower's Fiscal Responsibility Law (Law No 614/2019).

Prior Action 2: The Borrower has enacted legislation that conditions annual adjustments of the Borrower's civil servants' salaries on the Borrower's fiscal capacity, as evidenced by the adoption and publication of Law No 10.819/2019.

Prior Action 3: The Borrower has enacted legislation that strengthens the governance of its pension agency (MTPREV) by transferring the authority to approve actuarial studies and propose financing plans, as evidenced by the adoption and publication of Law No 613/2019.

Prior Action 4: The borrower has enacted legislation that establishes its State Fiscal Equilibrium Fund (FEEF) to increase public revenues from companies benefitting from tax incentives, as evidenced by the adoption and publication of Law No 10.709/2018.

Prior Action 5: The Borrower has enacted legislation that increases the per-unit levies charged on agricultural commodities produced in the Borrower's territory, as evidenced by the adoption and publication of Law No 10.818/2019.

Pillar B: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

Prior Action 6: The Borrower has enacted regulation that improves prevention and control of illegal deforestation and forest fires through remote sensing, early warning and swift response, as evidenced by the adoption and publication of the Borrower's Decree No 1490/2018.

Prior Action 7: The Borrower has improved the transparency and effectiveness of the Rural Environmental Registry and of the Program for Environmental Regularization through: (i) the definition of procedures and oversight for the Rural Environmental Registry and the Program for Environmental Regularization, as evidenced by the agreement signed among the Borrower's Public Prosecutor, the Borrower's Secretary for Environment and the Borrower's Secretary for Public Security; and (ii) the definition of operational procedures for public access to environmental information, as evidenced by the settlement signed between the Borrower's Public Prosecutor and the Borrower's Secretary for Environment.

Prior Action 8: The Borrower has enacted regulation that strengthens the implementation of its “Produce, Conserve, Include” (PCI) Strategy and institutional capacity (including by appointing the PCI Institute as the independent agency to implement its PCI Strategy) in order to improve agricultural production while protecting its forests, as evidenced by the adoption and publication of the Borrower's Decree No 46/2019.

c. Comments on Program Cost, Financing and Dates

The operation was approved on May 24, 2019, became effective on September 6, 2019, and closed on December 31, 2021.

The IBRD loan was approved for USD 250,000,000 and USD 248,883,034 was disbursed. The difference reflects exchange rates movements.

3. Relevance of Design

a. Relevance of Objectives

Relevance to country context: The program was highly relevant to the country context, with the country and state facing fiscal as well as environmental challenges.

- At the time of appraisal in 2019, Brazil's economy was slowly recovering from a deep recession in 2015 and 2016. Spending increases, and the impact of the recession contributed to a large federal fiscal deficit and growing public debt. Deep cuts to public investment and other austerity measures since 2015 were insufficient to control public expenditures, which has been growing strongly for several decades, largely due to constitutionally guaranteed social mandates such as pension benefits. The difficult fiscal position extended to subnational governments. Public expenditure, mainly on wage bill and public pension entitlements, grew as a result of pro-cyclical fiscal rules and growing demand for public services.
- At the time of appraisal, the Government of the state of Mato Grosso (the Government) was running arrears (similar to other states) despite relatively strong growth. Revenues trailed economic growth as production of agricultural commodities for export were exempt by federal legislation from the state's value-added tax and states could not tax rural properties since the rural property tax was assigned to the Federal Government. However, the Government continued to produce primary surpluses.
- The state's expenditures were dominated by high and rising personnel costs. Spending on payroll and pensions had grown 69 percent in real terms from 2011 to 2018, increasing from 50 percent of public spending in 2011 to 74 percent in 2018. Most of the increase was due to salary growth, due in part to a 2004 law that granted civil servants universal wage adjustments for inflation, and a 2013 law that aimed to double real wages for teachers between 2014 and 2023. The state was also facing a rapidly increasing pension deficit, as the number of retired civil servants was increasing rapidly, and their pensions were linked to the wages of active staff. The Government also had to contend with significant budgetary rigidities as 27 percent of tax revenues were earmarked for education and 12.5 percent for health.
- The state of Mato Grosso is Brazil's third largest by area and over 50 percent of the state's GDP is related to agriculture. Historically, the state's agricultural growth benefitted from the clearing of forest. Average deforestation fell between 2010 and 2019 considerably below levels from 2001 to 2009. However, it had started to increase again in 2016. In 2018, about 1,750 km2 of forests were cleared in the Amazon biome—130 percent above the low point in 2012. The expansion of agricultural production into previously forested lands was a leading contributor to carbon emissions. Moreover, interannual climate variability was impacting crop production patterns.
- Preserving its rich environmental resources was a high priority for the government to sustain an export-growth model based on sustainable agriculture. The Government had developed an ambitious PCI strategy to support sustainable agricultural and livestock production, while limiting deforestation and

forest degradation. Prior actions supported by the DPO were expected to put Mato Grosso in a leadership position on the environmental, climate and inclusive rural development agenda in Brazil, providing an important model for other states.

Relevance to country development agenda: The DPL was relevant to the country and state development agenda, expressed at the state level by the newly elected administration.

- Mato Grosso had a new state administration as of January 2019 which gave greater importance to accelerating fiscal adjustment and sustainable management of its natural resources. Within its first month in office, the new administration declared a "financial calamity" and approved a package of fiscal adjustment and reform measures, which included many reforms supported by the DPL. These measures focused on expenditure control, including the State Fiscal Responsibility law, changes to public sector pay adjustments, changes of the State's public pension system and an administrative reform, reducing the number of State Secretariats and allowing for the closure of State companies. It also increased levies on the main agricultural commodities produced in the State.
- Following the United Nations Framework Convention on Climate Change Paris Agreement negotiations, the Government adopted an ambitious strategy aimed at reducing deforestation by 90 percent and 95 percent in the Amazon and Cerrado biomes, respectively, by 2030. It also announced its strategy, "Produce, Conserve, Include (PCI)" that was designed to protect forest assets while promoting agricultural productivity by scaling-up efforts to reduce deforestation and forest fires, accelerating implementation of the environmental regularization in private properties, and institutionalizing the PCI program. The PCI program focuses on efforts covering DPL reforms including scaling-up efforts to reduce deforestation and forest fires, accelerating implementation of the environmental regularization in private properties, and institutionalizing the PCI strategy.

Relevance to Bank Group Strategy: The DPL was aligned with the first and third pillars of the World Bank Group supported Country Partnership Framework (CPF) for Brazil for FY2018-FY2023: (i) fiscal consolidation and government effectiveness; and (iii) equitable and sustainable development.

- It supported the first objective of the CPF's first pillar: *Strengthen fiscal management at all levels of government* by supporting the state's fiscal adjustment in close cooperation with the Federal Government. The ICR notes that the DPL was expected to have a demonstration effect for other subnational governments and was expected to create an incentive for states to address their fiscal deficits, reduce risk of unsustainable debt paths and restore the fiscal capacity of subnational entities to receive federal guarantees for further borrowing, all while reducing contingent liabilities to the Federal Government.
- The DPL also supported the first objective of the CPF's third pillar: *Support the achievement of Brazil's Nationally Determined Contribution with a particular focus on land use* by focusing on land use planning, deforestation, environmental compliance, and environmental climate finance mechanisms in a state that is considered critical to Brazil's climate mitigation commitment, and which relies on adaptation and climate resilience efforts to sustain its growth model.

b. Relevance of Prior Actions

Rationale

Objective 1: Regaining Fiscal Sustainability

Prior Action 1: The Borrower has enacted legislation that clarifies and tightens personnel spending limits and sets targets for current savings, as evidenced by the adoption and publication of the Borrower's Fiscal Responsibility Law (Law No 614/2019).

The adoption of the states' Fiscal Responsibility Law complements the national fiscal responsibility law by providing more stringent expenditure rules, particularly for wage expenditure, which is one of the largest spending items. It provides a clearer and broader definition of personnel expenditures that reduces the scope of interpretation and clarifies the definition of "adjusted net current revenue," which determines the available revenues for discretionary spending.

The law states that: (i) when total personnel spending exceeds 60 percent of "adjusted net current revenue", salaries cannot be increased, even if pay rises were approved in previous laws; (ii) current administrations cannot approve pay increases that come into effect in subsequent administrations; (iii) any new expenditure program must be evaluated by the Secretariat of Finance (SEFAZ) for fiscal impact and sustainability; (iv) the total amount of tax incentives that can be provided to businesses on any given tax is limited to a fixed percentage of gross revenues from that same tax (25 percent for the tax on circulation of goods and services (ICMS)); and (v) the State Government must achieve a current savings rate of 8 percent in the medium term (8 years). Achieving this savings rate would allow the State to regain access to borrowing with federal guarantees.

PA1 was highly relevant to the achievement of PDO1 since the State could not achieve fiscal sustainability without strong actions to control expenditures and increase savings. While the measures could be expected to contribute towards containing personnel spending costs below the 60 percent ceiling by limiting the circumstances under which salaries can be increased, by maintaining targets as a function of adjusted net current revenue, this does not, on its own, deal with some other problems, such as high levels of pro-cyclicality. Although a stronger fiscal rule would have reduced pro-cyclical elements by relying on historical revenue trends over time or having some other cap on expenditure growth, this DPO and prior action was working within the confines of the federal fiscal responsibility law and credit rating requirements. Defining new means of measurement would have set this on a different path for monitoring and evaluation solely for WB purposes, instead of what was already being done in government. Some of the pro-cyclical elements were addressed by using a weighted average over three years. ***Rating: highly satisfactory.***

Prior Action 2: The Borrower has enacted legislation that conditions annual adjustments of the Borrower's civil servants' salaries on the Borrower's fiscal capacity, as evidenced by the adoption and publication of Law No 10.819/2019.

The increase in the public sector wage bill and pensions were the largest vulnerabilities to the state's fiscal situation, and this PA more tightly regulated growth of public sector salaries. This modified a pre-existing law that regulated pay increases to all civil servants to be in line with the national consumer price index. Although the previous law required that the state's financial capacity ***be considered*** when granting salary increases, language was vague and in practice increases had become automatic.

This new law formalized the fiscal conditions that needed to be met for the inflation-based adjustment to be granted, including that the state: (i) had available fiscal capacity (ordinary net revenues greater than total expenditures not financed from other sources), considering the most recent 12-month data; and (ii) ensured that any salary increase would not lead to a loss of this fiscal capacity. The Law conditioning civil servants' salary increases remains in place and effective, and no new salary increases (besides individual career progression) were granted in both 2019 and 2020.

This prior action clearly limits the application of inflation adjustments to salaries, which has been a major problem in Mato Grasso and Brazil, by clarifying and limiting the conditions under which they can be applied. While it has been effective in this case through 2020, it also faces a similar concern as PA1, where it is tied to the most recent revenue figures, which could increase pro-cyclicality. While certainly constrained by country circumstances, a more effective law may have tied this to trend revenues over a longer period than 12 months, in order to reduce pro-cyclicality. ***Rating: satisfactory.***

Prior Action 3: The Borrower has enacted legislation that strengthens the governance of its pension agency (MTPREV) by transferring the authority to approve actuarial studies and propose financing plans, as evidenced by the adoption and publication of Law No 613/2019.

The MTPREV had been created in 2014 to be the single administrator of the state's pension system, but the incorporation of non-executive branches of government foreseen in the law had not taken place. These branches were represented in the MTPREV Council, which allowed them to prevent changes to the pension system governed by MTPREV. MTPREV had blocked the MTPREV's ability to commission actuarial studies showing growing deficits and to approve proposals aimed at addressing the deficits, even before the proposals could be advanced to the legislature for approval.

This reform was the approval of a law which authorized the MTPREV directory (instead of the Council) to approve actuarial studies and propose financing plans for deficits identified in the studies. These changes were expected to allow the state to make parametric changes to its pension system, aimed at reducing short- and long-terms deficits.

High spending on pensions is a key component of public expenditure. This reform helped unblock the analysis of these issues and allowed the government to make proposals to the legislature to reduce these costs which had been blocked by the MTPREV council. However, this is only an early step in the process as necessitated by the circumstances at the time, and much more would be needed to make lasting pension reform. The PD acknowledged that this was an early step in the process, but was necessary to propose more parametric reforms (the government subsequently made significant progress on pension reform). ***Rating: moderately satisfactory.***

Prior Action 4: The borrower has enacted legislation that establishes its State Fiscal Equilibrium Fund (FEEF) to increase public revenue from companies benefitting from tax incentives, as evidenced by the adoption and publication of Law No 10.709/2018.

In Mato Grosso, fiscal incentives were estimated to forgo tax revenues of R$3.5 billion a year, or 27 percent of expected total tax revenues in 2018. The concession of new benefits was already limited by the state's new Fiscal Responsibility Law, but there was a need to recover part of the previously granted tax expenditures in a way that was consistent with the legislation that granted them.

As a Prior Action, the state created a fiscal emergency fund (the FEEF) and companies that were benefitting from certain tax exemptions were obliged to contribute to the fund, in effect resulting in a partial and temporary "claw back" of the previously granted tax benefit. Contributions were set at between 10 and 20 percent of the benefit received (depending on the sector) until June 2021 (when FEEF was to expire) for those benefitting from two main programs.

The ICR acknowledges how the creation of the FEEF was a “second-best” solution for quick fiscal gains at the time. There was a deeper reform eliminating many of these tax exemptions about a year later. However, political capital was not sufficient to pass the more substantive reform at the time of the DPL, although there was a need for recovering revenues at the time. The design team was involved in the preparation of the more structural reform, but for the government it was more important to front-load the rest of the fiscal package supported and present this reform later. ***Rating: moderately satisfactory.***

Prior Action 5: The Borrower has enacted legislation that increases the per-unit levies charged on agricultural commodities produced in the Borrower’s territory, as evidenced by the adoption and publication of Law No 10.818/2019.

The state’s main economic activity, export-oriented agriculture, is exempt from ICMS (VAT) taxation by federal law. Therefore, to capture part of the agriculture’s value added and to help finance public infrastructure, the state created the state FETHAB in 2000, and as such, a levy was charged on the state’s main agricultural export crops (soybean, maize, cotton, cattle, wood) and on diesel fuel consumption. The levies are not permanent and have to be renewed every few years. Resources were shared with municipalities, and until 2018, were largely earmarked for transport infrastructure and housing investments. The higher rates on commodities— rates levied on agricultural commodities (excluding cattle were doubled in 2017 and 2018, expired at the end of 2018, threatening a reduction of FETHAB revenues of around 32 percent.

This reform supported actions to strengthen fiscal sustainability by extending existing revenue measures in the short- to medium-term, and to introduce greater flexibility in the budgetary allocations of those revenues in the short term. This prior action was for the state to approve a law that would adjust the state Fund for Transport and Housing (FETHAB) to provide greater budget flexibility by: (i) renewing the FETHAB on commodities from 2019 to 2022; (ii) setting rates on agricultural commodities above the rates prevailing until December 2018, broadening the coverage of the FETHAB on livestock production and introducing a new level on maize destined for out-of-state consumption; and (iii) increasing the non-earmarked share of revenues from 30 percent to 60 percent for 2019 and 2020, then gradually declining to 40 percent by 2023. As of August 2022, the FETHAB for commodities has accumulated R$1,911.5 and it is expected to be above the revenues collected in 2021.

The reform provided a clear increase in revenues in the short and medium term, and by raising the rate above previously prevailing rates, it set a baseline for future cycles. But due to political considerations, this was only able to continue the short term system of extensions instead of implementing long term solutions – although the objective does target more short and medium term objectives of “regaining fiscal sustainability”. ***Rating: moderately satisfactory.***

Objective 2: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

Prior Action 6: The Borrower has enacted regulation that improves prevention and control of illegal deforestation and forest fires through remote sensing, early warning and swift response, as evidenced by the adoption and publication of the Borrower’s Decree No 1490/2018.

Mato Grosso has the second highest level of deforestation in the Amazon biome, and deforestation was rising again at the time of appraisal. Reversing the upward trend in the rate of deforestation is made difficult by State’s large dimensions, remoteness of affected areas and obsolete monitoring and controlling systems – the existing satellite monitoring system provides information with an average delay of 45 days. The State established its first Deforestation and Forest Fire Prevention and Control Plan in 2013. However, this plan expired in 2016 and since then the State lacked a proper coordination mechanism to prevent and control illegal deforestation and forest fires.

The new plan supported by this prior action provides for: (i) the creation of an integrated monitoring center (the first of its kind in Brazil) to monitor and control legal and illegal deforestation, timber extraction, the quality of water, air, and soil, and all the information regarding the licensing process for investments with environmental impact; (ii) replacement of the existing obsolete satellite monitoring system through the adoption of a state-of-the-art satellite system providing information within 48 hours; (iii) training and capacity building of key operational partners, such as the Brazilian Institute of the Environment and Renewable Natural Resources, Polícia Militar Ambiental and Delegacia de Meio Ambiente, and (iv) confiscation of machinery from deforested areas, preventing them to be reused in other areas.

The resources for these activities are in large part provided through various existing programs and partnerships, providing a large degree of financial independence from the State's budget and substantially reducing the risk of delays in implementation due to lack of funding. Moreover, reform implementation can rely on initiatives such as the "MapBiomas Alertas" initiative, a multi-institutional project involving universities, NGOs and technology companies that promotes Brazil's annual land cover and land use mapping over the last three decades, and provides free and open data and maps. This type of collaboration can help validate deforestation alerts in a shorter time, allowing effective action even at the most remote points.

While establishing this coordination mechanism and the integrated monitoring center, replacing the obsolete satellite monitoring system, and training and capacity building will certainly aid in addressing deforestation, supporting these activities would have been better suited for an investment project than a DPO (the PDO targets "increasing institutional capacity" which is not well suited for a DPO). Moreover, the PD indicates how resources for these activities are already largely available, but it is not clear how this regulation was a key binding constraint. ***Rating: moderately unsatisfactory.***

Prior Action 7: The Borrower has improved the transparency and effectiveness of the Rural Environmental Registry and of the Program for Environmental Regularization through: (i) the definition of procedures and oversight for the Rural Environmental Registry and the Program for Environmental Regularization, as evidenced by the agreement signed among the Borrower's Public Prosecutor, the Borrower's Secretary for Environment and the Borrower's Secretary for Public Security; and (ii) the definition of operational procedures for public access to environmental information, as evidenced by the settlement signed between the Borrower's Public Prosecutor and the Borrower's Secretary for Environment.

This prior action entailed two interrelated measures to support the implementation of the cadaster in compliance with the Brazilian Forest Code through:

i. defining procedures and oversight for the Rural Environmental Registry and the Program for Environmental Regularization.
    a. This was expected to remove the most significant barrier in the swift application of SIMCAR (the environmental registry) by clarifying implementation procedures between SEMA (the state Environment Secretariat), the Secretariat for Public Security and the Public Prosecutor, simplifying the analysis of data, and strengthening control systems.
ii. defining operational procedures for public access to environmental information.

a. SEMA's Transparency Portal was to provide environmental information such as SIMCAR data, licenses and permits, information about embargoed areas, and data related to the control of commercialization and transport of forest products, which supported implementation of Brazil's Forest Cost and curbed non-compliance.

The capacity for putting in place an updated environmental registry, validated by relevant authorities, in compliance with federal legislation, and with information readily accessible to interested parties through this reform would support the achievement of PDO2. Implementation had been slow due to limited financial and human resources and lack of a clear and transparent implementation process. The lack of transparency on environmental permits and registry entries undermined effective monitoring and oversight.

Improving the clarity of procedures are likely to impact the effectiveness of implementing the forest code as well as monitoring and oversight, but the PD also indicates that limited financial and human resources play a role. So while this reform may make some progress towards PDO2, it is not clear how much this was an impediment instead of just financial and human resources constraints, or other technical constraints. ***Rating: moderately satisfactory.***

Prior Action 8: The Borrower has enacted regulation that strengthens the implementation of its PCI Strategy and institutional capacity (including by appointing the PCI Institute as the independent agency to implement its PCI Strategy) in order to improve agricultural production while protecting its forests, as evidenced by the adoption and publication of the Borrower's Decree No 46/2019.

This reform helped put in place an institutional structure to coordinate with donors and investors to help mobilize funding for the state's transition to sustainable agriculture. The state's PCI Strategy represented a long-term development vision for the state, but the state lacked a coherent institutional framework to implement the strategy, hampering coordination and scalability of existing programs and initiative between stakeholders (e.g., research institutes, NGOs, sector associations, civil society, government). It had also not created the enabling environment to attract environmentally-minded donors and investors at scale, raising the difficulty to reach its PCI goals. Removing barriers to green finance was considered key as the transition of Mato Grosso's agriculture and livestock production to ambitious low carbon, climate resilient and environmental standards was expected to require substantial investments.

To achieve this, the Government sought to create an institutional structure that would: (i) help coordinate the dialogue with donors and investors; (ii) raise resources for the transition to sustainable agriculture aiming at climate co-benefits; (iii) advise on public policies and measures and on a balanced mix of innovative technical and financial incentives; and (iv) provide technical assistance to create a robust monitoring, reporting and verification system to evaluate programs and projects implemented under the PCI strategy. The PCI Institute was founded in early 2019 as a private non-profit institution for the above purposes. ***Rating: moderately satisfactory.***

Rating

Moderately Satisfactory

4. Relevance of Results Indicators

Rationale

RI description	Associated PA(s)	RI Relevance	Baseline (including units and date)	Target (including units and date)	Actual value as of target date	Actual change in RI relative to targeted change	RI achievement rating
Objective 1: Regaining Fiscal Sustainability							
Current savings as a percentage of adjusted net current revenue (assesses using the current savings indicator established and published by the STN)	PA1	Moderately satisfactory	3.6 percent (data up to 2017)	5 percent (2021)	13.2 percent (2021)	Over 100 percent of targeted change	High
Wage bill as a share of net-current revenue	PA2	Moderately satisfactory	67.85 percent (2018)	60 percent (2021)	52 percent (2021)	Over 100 percent of targeted change	High
Pension deficit realized in percent of current revenues compared to 2018 projection (based on World Bank PROST model)	PA3	Moderately satisfactory	9.1 percent (2018)	8.5 percent (2021)	1.6 percent (2021)	Over 100 percent of targeted change	High
Revenues recovered by FEEF (cumulative total)	PA4	Satisfactory	R$85 million (2018)	R$400 million (2021)	R$384 million (2021)	95 percent of targeted change	Substantial
Revenues raised from FETHAB commodities (annually)	PA5	Satisfactory	R$870 million (2018)	R$1,350 million (2021)	R$2077.6 million (2021)	Over 100 percent of targeted change	High
Objective 2: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation							
Annual deforestation in Mato Grosso's portion of the Amazon biome	PA6	Moderately satisfactory	1,749 km2, revised to	1,241 km2 (2021)	1,438 km2 (2021)	21 percent of	Negligible

			1,490 km2 (2018)			targeted change	
Area of land for which CAR information has been validated by SEMA (cumulative total)	PA7	Moderately satisfactory	2.9 million hectares (2018)	20 million hectares (2021)	7.9 million hectares (2021)	29 percent of targeted change	Modest
International and domestic resources mobilized in coordination with the PCI Institute for the purpose of implementing the PCI strategy (cumulative total)	PA8	Moderately unsatisfactory	US$53 million (2018)	US$90 million (2021)	US$125.3 million (2021)	Over 100 percent of targeted change	Substantial

Objective 1: Regaining Fiscal Sustainability

RI1: The main intention and part of the prior action is to increase the current savings rate as a share of adjusted net current revenue through various means, including through tighter controls of personnel spending and evaluating the impact of expenditure programs on fiscal sustainability, as well as limiting the granting of tax incentives While achieving this overall savings rate is part of the reform itself, this can be affected by various expenditure and revenue measures, as well as having as a denominator a variable influenced by a range of factors. ***Rating: moderately satisfactory***.

RI2: Part of the reform is that for salaries to be increased, the state must have available fiscal capacity (ordinary net revenues greater than total expenditures not financed from other sources) and ensuring that any salary increase would not lead to a loss of this fiscal capacity. While the denominator is tied in as part of the reform measure itself, the wage bill as a share of net current revenues faces a drawback of having a denominator that is beyond the control of the reform. ***Rating: moderately satisfactory.***

RI3: The reform is intended to allow the state to make parametric changes to its pension system with the intention to reduce short and long-term deficit. The indicator measures the deficit of the pension system as a share of net current revenues. While the deficit itself would be influenced by the reform, it would rely on further subsequent actions, and net current revenues would be affected by many other factors. ***Rating: moderately satisfactory.***

RI4: The reform targeted increasing revenues to the FEEF which was also the indicator. While this was a nominal figure, inflation was relatively low (below 5 percent) during the period. This could have instead targeted the share of tax incentives received or share of tax revenues, but the denominator for these other indicators would have been affected by other factors outside the control of the reform. ***Rating: satisfactory.***

RI5: The reform directly targeted the levy for funding the FETHAB, which is also the indicator. While this was a nominal figure, inflation was relatively low (below 5 percent) during the period. ***Rating: satisfactory.***

Objective 2: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

RI6: The reforms provide various measures through which the state can reduce deforestation and the indicator provides an appropriate outcome measure for measuring how effectively the state is able to do so. The indicator does not measure increasing institutional capacity, but rather the potential impact of increasing institutional capacity. It can also be affected by outside factors, such as occurred in this case, where the macro-economic situation, drought, reduced SEMA presence in the field due to COVID-19, and the need to coordinate efforts with other states also affected the indicator. ***Rating: moderately satisfactory.***

RI7: The reform intended to increase enforcement of the forestry code by expanding the SIMCAR coverage to more land area and having this validated by the respective authority (SIMA), with land covered in the CAR as the indicator. Other factors beyond this reform could affect this outcome (namely sufficient human and financial resources), as well as technical issues (e.g., discrepancies in the hydrography database and rural properties' CARs). ***Rating: moderately satisfactory.***

RI8: The PD indicates how this reform promotes the institutionalization of the agency for raising carbon financing, by helping put in place an institutional structure to coordinate with donors and investors to help mobilize funding for the state's transition to sustainable agriculture. It also is intended to coordinate dialogue with donors, advise on public policies and measures, provide TA to support robust monitoring, reporting and verification system to evaluate programs implemented under the PCI strategy. Raising resources is a major component of this, but it is only one aspect of the mandate of the PCI institute, and is only one step forward in reaching PDO2. ***Rating: moderately unsatisfactory.***

Rating

Moderately Satisfactory

5. Achievement of Objectives (Efficacy)

OBJECTIVE 1

Objective

Regaining Fiscal Sustainability

Rationale

RI1: achievement rated high. Current savings as a percentage of adjusted net current revenue reached 13.2 percent as of 2021, far higher than the 5 percent targeted, and also significantly above the baseline of 3.2 percent.

RI2: achievement rated high. Personnel spending as a share of net current revenue declined far further than the target of 60 percent to 52 percent.

RI3: achievement rated high. Pension deficit realized in percent of current revenues compared to 2018 projection far exceeded the target of reducing from 9.1 to 8.5 percent by reaching 1.6 percent.

Following the changes to the MTPREV governance structure supported by the PA, various measures were approved to reduce the pension deficit. The state prepared a social security reform package which included changes in benefits (pensions) and contributions to the social security system which aim to reduce the deficit of the state regime itself. In late 2019, the state adopted a law that increased the pension contribution rate from 11 percent to 14 percent for active and retired civil servants and expanded contribution base of retirees and pensioners. Since June 2020, contributions are collected on benefit payments above the minimum wage. In August 2020, the state legislature approved a law increasing the retirement age and to reduce replacement rate for survivor benefit. In November 2020, the state has also implemented a complementary capitalized pension scheme.

RI4: achievement rated substantial. Revenues recovered by FEEF reached 95 percent of the targeted change, increasing from R$85 million to R$384 million, falling just short of the R$ 400 million target.

RI5: achievement rated high. Revenues raised annually from FETHAB commodities far exceeded the targeted, increasing from R$ 870 million to R$2077.6 million, far above the R$1,350 target.

The combined rating of objective 1 is satisfactory.

Rating

Satisfactory

OBJECTIVE 2

Objective

Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

Rationale

RI6: achievement rated negligible. Annual deforestation only reached 21 percent of the targeted change. Outside factors affected the achievement of this, including the macro-economic situation, drought, reduced SEMA presence in the field due to COVID-19, and the need to coordinate efforts with other states.

The ICR argues how the state strengthened its institutional capacity for forest conservation through other means than measured by the RI. It implemented its Plan to Combat Deforestation and Forest Fires and intensified several measures and actions to combat deforestation, including activation of an Integrated Multi-Agency Committee; the use of the Planet Satellite Image Monitoring Platform as a preventative environmental control tool; the use of the integrated monitoring center/situation room for actions of intelligence, informed strategic planning and decision making; the strengthening of SEMA's judicial team responsible for the oversight measures and anticipation of collection of fines; and creation of Integrated Centers of Command

and Mobile Control advanced mobile bases to allow for the geospatial information to reach the field in real time.

RI7: achievement rated modest. The area of land for which CAR information has been validated by SEMA reached only 29 percent of the targeted change. The ICR notes how various factors slowed the process (discrepancies in hydrography database and CARs from rural areas have numerous inconsistencies), and after sorting through these issues, improving technical capacity, and the strengthening of the analysis processes reflect improvements in the environmental regularization in the state, and the target of 20 million hectares of validated CARs by SEMA is expected to be achieved in the near future.

RI8: achievement rated substantial. The indicator reached over 100 percent of the targeted change, with international and domestic resources mobilized in coordination with PCI reaching $125.3 million by 2021, far above the target of $90 million; however, the relevance of the results indicator was moderately unsatisfactory.

The combined rating of objective 2 is moderately unsatisfactory.

Rating

Moderately Unsatisfactory

Overall Achievement of Objectives (Efficacy)
Rationale

With the efficacy of the first objective rated satisfactory, the second rated moderately unsatisfactory, the overall efficacy of the project is rated moderately satisfactory.

Overall Efficacy Rating
Moderately Satisfactory

6. Outcome

Rationale

The relevance of the prior actions is rated **moderately satisfactory**.

The overall efficacy rating is **moderately satisfactory**.

The overall outcome rating is therefore **moderately satisfactory**.

a. Rating

Moderately Satisfactory

7. Risk to Development Outcome

Political risks are high. As the ICR notes, the results achieved for PDO 1 relied on commitment of the state Government. The Governor won reelection to another four-year term in October 2022 with an overwhelming majority, boding well for short term sustainability, but political support for reducing expenditure - particularly related to remuneration and pensions – as well as increasing revenues can quickly erode. Nonetheless, as the ICR notes, recent increases in savings have also benefitted the state by increasing the State Payment Capacity Assessment (CAPAG) score from C (the second worst score) in 2019 to an A in 2021 – which offers the positive benefit of allowing the state to access federal guarantees for borrowing.

Economic risks include how revenues can be highly affected by the economic cycle, which could derail savings plans and the country's commitment to them. There is also the need for Mato Grosso to diversify its economic base beyond agriculture in order to create more sustainable land demand.

Institutional risks – For objective 2, the institutions that were strengthened need additional time to achieve results under the program. Yet during this period, further capacity and technical issues could arise, which will require stronger commitment from the government but it also being supported by a WB IPF. There is a risk that sub-national level reforms could be derailed by actions in neighboring states or at the national level.

8. Assessment of Bank Performance

a. Bank Performance – Design

Rationale

Drawing on lessons from previous operations: The DPO was the first of a potential series of subnational DPLs to support fiscal adjustment and sustainable development for subnational entities and it was expected to have a demonstration affect for other subnational governments. While there was substantial experience in supporting previous fiscal reforms through DPOs at the sub-national level – which this DPO benefitted from -- less experience and analytical work was available to inform the second objective, which affected the understanding of the theory of change of reforms, their expected impact, and achievement of results.

The PD indicates how the design of the fiscal pillar incorporated lessons learned from numerous previous subnational DPFs in Brazil. This included incorporating lessons on: (i) subnational DPFs to support fiscal adjustment programs in states and municipalities need to include fiscal measures that are sufficient to achieve relevant fiscal outcomes, and these measures need to be front-loaded to contain moral hazard; (ii) ownership and leadership at the highest level are needed, and the beginning of the political cycle is the most promising time for reforms; (iii) close collaboration with the relevant federal agencies strengthens the design of a fiscal program and monitoring of subnational governments' fiscal status.

The PD discussed how the design of the second pillar benefited from the experience of the first subnational DPL in Brazil focused on climate change and environmental issues, and incorporated lessons by (i) including in reform preparation and implementation the state legislative assembly, international organizations, private sector and academia to ensure strong inter-institutional leadership and coordination; (ii) supporting the institutionalization of the PCI to ensure policy continuity; and (iii) supporting policies with strong monitoring and evaluation mechanisms such as the interagency process for the rural land cadaster (CAR) and the multi-stakeholder Instituto PCI. However, the institutional capacity building focus of the second pillar raises the question of whether a DPO was the right instrument to achieve this aim.

Analytical foundations: While the first pillar benefitted from substantial technical and analytical work, this was not the case for the second pillar.

For the first pillar, this included the Brazil PER's analysis on fiscal sustainability, public sector wage bill, pensions and education spending; analytical work done in intergovernmental fiscal relations in collaboration with the Federal Treasury; analytical work on subnational pensions in Brazil; and specific models on pension, wage bill and taxes developed for Mato Grosso.

While the second pillar relied on numerous studies on environmental issues prepared by the Government and outside agencies and professionals, the only WB analytical work supporting this was carried out in 2005. The ICR notes how part of the challenges observed in the attainment of the second pillar were related to the lack of similar deep understanding of the theory of change of the reforms and the impact expected, therefore affecting the achievement of the targets for the result indicators.

Risk identification and mitigation measures: The PD identified risks to the DPO as substantial. It highlighted macroeconomic risks arising mainly from uncertainty in the pace of reforms at the federal level, as well as from potential volatility in Mato Grosso's export volumes and prices. It discussed how pension reforms will require further actions, including federal government reform in this area and with the need to take reforms early in the political cycle. Additionally, it discussed institutional risks to fiscal reforms, as well as highlighted how capacity constraints are a higher risk for the second pillar and some mitigation measures that should help alleviate this (e.g., SEMA's earmarked resources and existing external funding). It identified environmental risks, acknowledging how land use change is a private sector decision. It described stakeholder risks as substantial, particularly for public spending and public-sector payroll.

Consultations with stakeholders: Public consultations in Mato Grosso took place both during preparation of public policies and during approval in the State legislature. The State government undertook an extensive consultation process on the State's fiscal adjustment program, gaining the backing of elected representatives and involving stakeholders within and outside the government including public sector unions, and revenue measures were discussed with industry and agribusiness representatives. The World Bank team worked in close partnership with the National Treasury Secretariat (the Federal Government agency that supervises fiscal affairs of subnational government), which joined missions to the State and participated in the development of the fiscal adjustment program.

The DPO's second pillar policies were discussed with stakeholders and civil society, including for the Plan to Combat Deforestation and Forest Fires and for the "PCI Strategy Implementation Plan in Mato Grosso,". SIMCAR and PRA land regularization policies were developed with public consultation over several years. The WB team consulted with international development partners working with Mato Grosso and other States on the climate change agenda, including Agence France de Développement, the Sustainable Trade

Initiative of the Netherlands, the German Gesellschaft für Internationale Zusammenarbeit, and the German Development Bank, which is directly involved in the State's REDD financing.

Rating

Moderately Satisfactory

b. Bank Performance – Implementation

Rationale

As discussed in the ICR, implementation support was strong, particularly for a stand alone DPO. Four Implementation Status Reports were prepared after five hands-on supervision missions for which detailed Aide Memoires were prepared, which detailed progress and challenges by policy areas, prior actions and results. The task team helped identify sources of financing for needed technical assistance, both from the World Bank through future operations and through other donors (i.e., KfW) with whom the team maintained regular and agile contact. Finally, the implementation team continued providing support to the Government to help address the next-step actions to help ensure sustainability of the results achieved thus far, and to make progress in areas where adjustment was warranted.

Rating

Highly Satisfactory

c. Overall Bank Performance

Rationale

Program design is rated moderately satisfactory. Program implementation is rated highly satisfactory. Overall Bank performance is rated satisfactory.

Overall Bank Performance Rating

Satisfactory

9. Other Impacts

a. Social and Poverty

The DPO's reforms were not expected to have adverse effects on poverty and inclusion, but some positive effects were expected in the medium to long term due to expected spending cuts that would enhance equity, including for civil servants - who were typically among the top 40 percent of income earners in the state.

The Plan to Combat Deforestation and Forest Fires (PA#6) was expected to have some positive impacts on poor indigenous populations who derive their livelihoods from sustainable forest management and are threatened by forest fires. However, because deforestation didn't not decrease, the ICR discussed how it is expected that these populations were negatively impacted,but did not offer further evidence.

No information was provided on actual impacts.

b. Environmental

DPO reforms were not expected to cause negative effect on the environment, forests or other natural resources, with limited significant effects from the first pillar of the DPO. Reforms under the second pillar were designed to help to help improve environmental management and are discussed in sections 3, 4, and 5 above.

No information was provided on actual impacts.

c. Gender

ICR does not discuss specific gender impacts.

d. Other

Not discussed in ICR

10. Quality of ICR

Rationale

The quality of the ICR was substantial. The assessments of both the relevance of the prior actions and the results indicators were candid and included sufficient evidence to assess efficacy. It provided further discussion of the reasons behind why various indicators were not met, and an assessment of the outlook for achieving them. The ICR's lessons were also based on evidence discussed in the report and would have value for future DPOs, especially those at a sub-national level.

a. Rating

Substantial

11. Ratings

Ratings	ICR	IEG	Reason for Disagreement/Comments
Outcome	Satisfactory	Moderately Satisfactory	Relevance of PAs rated MS (vs HS in ICR – with several PAs being downgraded) and efficacy rated MS (vs S in ICR - with the efficacy of the first objective rated moderately satisfactory, the second rated moderately unsatisfactory).
Bank Performance	Satisfactory	Satisfactory	
Relevance of Results Indicators	---	Moderately Satisfactory	
Quality of ICR	---	Substantial	

12. Lessons

Strong WB engagement and analytical work is important to support technical capacity for reforms as well as to better understand which reforms will help move the agenda forward. This DPO presented an example of this working well with the first objective, which was supported by fiscal analytical tools and an evidence-based dialogue with two consecutive administrations and between the state and federal government. This helped to build trust across stakeholders which led to reform implementation when the political interest (at federal and state level) aligned, and also led to a realistic approach to fiscal indicators and targets. However, the DPO's second objective suffered from the lack of similar deep understanding of the theory of change of the reforms and the impact expected.

Selecting results indicators and establishing targets are challenging in a federal environment, where existing monitoring and evaluation systems are already setup in the government, and where they can be affected by exogenous events. Fiscal indicators were defined in relation to the state's current revenues, which could be impacted by macroeconomic cycles as well as the federal government's increase in transfers to the states to mitigate the impact of the COVID-19 pandemic. Other unforeseen events could similarly impact these in the future. Indicators could be defined as current revenues net of extraordinary transfers to better measure progress, and other measures should be considered for reducing impact of economic cycles. However, there is also a cost in creating new indicators which the government isn't already tracking. Additionally, exogenous factors complicated measuring results, particularly in the case of a drought enabled illegal deforestation in months normally naturally shielded from such events, COVID-related social distancing reducing government's field presence. In this case, more output (vs outcome) related indicators could have better measured results.

Strong Government commitment, and the timing of engagement at the start of an administration, can provide an important window of opportunity for frontloading a reform program. The experience in Brazil demonstrated that a new Government could advance important reform initiatives during the first 12-24 months of administration, but later on reform momentum slows down.

13. Project Performance Assessment Report (PPAR) Recommended?

No